worldmags

Investing
Worthless Stocks From China
p58

Wireless
Seidenberg Takes A Verizon/iPhone Victory Lap
p32

Etc.
Meet Your Robot Replacement
p69

Plus
The CEO's Dilemma: When to Hire p22
How to Play Takeover Rumors p36
Microsoft's Hacker Magnet p28
The Boom in Gay Sports Bars p72
BP's $22 Billion Garage Sale p16

January 17 — January 23, 2011 | businessweek.com

Bloomberg Businessweek

The Killing Machine



How Austria's Glock Became America's Gun
p50

worldmags

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January 17 — January 23, 2011
Bloomberg Businessweek

Bloomberg Businessweek
Contents



In the bag
Your purse and your personality p76

Opening Remarks 6

Some of the freshest thinking in economics is decades old. For new ideas, dismal scientists are turning to the Depression-era insights of John Maynard Keynes and Friedrich Hayek

Global Economics 9

Power in the people
Countries with fast-rising working-age populations will be the future economic growth leaders

Diamond smuggling thrives in Zimbabwe p11
Mao nostalgia in China p12
Why that 101st employee is such a problem in India p13
Singapore's Prime Minister on the U.S. and China p13
Seven days ahead p14

Companies & Industries 16

Cash in Big Oil's trash
BP, Shell, and others are getting top prices for properties they thought they'd struggle to unload

DuPont: CEO Kullman's bet p17
Universal Music hopes for a buzz from *American Idol* p18
How cell providers get rich serving the poor p19
Marilyn Monroe and others are resurrected by marketers p20
Briefs p21

Politics & Policy 22

Is it safe to hire again?
U.S. companies won't add workers in earnest until they're convinced the recovery is real

The Administration's internal debate on tax reform p24
Bill Daley, fixer-in-chief p25
A shaky start for high-risk insurance pools p26
China comes to do deals p27

Technology 28

Microsoft, only Kinect!
The gaming accessory offers the tech giant a rare opportunity to harness the enthusiasm of hackers

A weird and wonderful CES p30
iPhone: The pros and cons of Verizon vs. AT&T p31
Charlie Rose talks to Verizon CEO Ivan Seidenberg p32
Speeding up gene research p34

Markets & Finance 36

Playing the rumor mill
The jump in stock prices of companies named in takeover chatter is often short-lived

Big banks, big legal bills 37
Morgan Stanley has something to prove p38
Why a housing rebound won't lift the economy p39
The stock-bond hybrid that burned investors p40
Bid & Ask: The week's deals p42

Enterprise 45

Healthy new business
Vending-machine startups are offering schools something besides potato chips and cookies

When it comes to IRS audits, size matters p46
Why St. Louis beer fans are drinking more Schlafly p47
Brett King on what small business needs from banks p47
A D&B spin-off for the Internet age p48



Shooting star The Glock is simple, quick-firing, and utterly reliable

Features 50

America's Gun
How Glock became the weapon of choice for U.S. cops, gun enthusiasts, and mass killers like alleged Tucson gunman Jared Loughner p50

Unmasking Chinese Fakes
When a retiree in Texas discovered that some mainland companies listed in the U.S. are frauds, he unleashed an army of short-sellers p58

Home Depot's Fix-It Lady
Chief Financial Officer Carol Tomé has a chance at becoming the next CEO—if she can help drag the company's technology into the 21st century p64

Etc. 69

Danger, Will Robinson! Your Cubemate is a Robot
Tomorrow's office is likely to include workers that are smarter, faster, more responsible–and not human

Food Gay sports bars are popping up around the U.S., and cleaning up p72
Next Life Former Hong Kong banker Jose Cortes turned a passion for African wildlife into a business adventure p74
One True Thing Fitness gear for New Year's resolution keeper and gym rat alike p75
Office Lab Your purse is talking about you. A guide to what it's saying p76
The Stack In *American Plastic*, Sociologist Laurie Esseg traces Americans' fixation back to Reagan-era tax cuts and deregulation and rising economic insecurity p78
Hard Choices American Federation of Teachers President Randi Weingarten on public education, teacher bonuses, and why unions are so unpopular p80

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Index



A
Abercrombie & Fitch 72
Aberdeen Group 69
Activision 20
Adafruit Industries 28
Advanced Micro Devices (AMD) 21
Airbus 21
Akamai Technologies (AKAM) 36
América Móvil (AMX) 19
American Eastern Group 58
Ameriprise Financial (AMP) 40
Anadarko Petroleum (APC) 16
Anderson, Pamela 78
Anheuser-Busch (BUD) 47
Anybots 69
Apache (APA) 16
Apple (AAPL) 14, 18, 28, 31, 32
Aramark 45
Assurance Wireless 19
Astellas Pharma 36
Atlantic Records 18
AT&T (T) 31, 32

B
Baidu (BIDU) 21
Ballmer, Steve 28
Bank of America (BAC) 14, 22, 37, 40, 64
Bank of Ireland 40
Barclays (BCS) 21
Basic Business Concepts 48
Beretta 50
BlackBerry (RIMM) 72
BNP Paribas 22
Boehner, John 26
Boeing (BA) 27
Boston Advisors 36
Boxers NYC 72
Bo, Xilai 12
BP (BP) 16
Brown, Gregory 27
Bush, George W. 27

C
Camp, Dave 24
Canteen 45
Cantor, Eric 26
Capitol Music Group 18
Caterpillar (CAT) 17
CBS (CBS) 18
CCG 58
CDNN Sports 50
Cerberus Capital Management 64
Chevron (CVX) 16
Chicago Board of Trade 25
Chicago Mercantile Exchange (CME) 25
China-Biotics (CHBT) 58
China National BlueStar 42
China National Nuclear 27
China Petrochemical 16
China Sky One Medical (CSKI) 58
Christie's 42
Cisco (CSCO) 20, 24
Citigroup (C) 14, 37, 38
Citron Research 58
Citysearch 48
CKx (CKXE) 18, 20
Clinton, Bill 25, 27
Clinton, Hillary 27
CME Group (CME) 25
CNOOC (CEO) 16
Coca-Cola (KO) 45
Colt 50
ConocoPhillips (COP) 16
Costco (COST) 31
Costner, Kevin 64
Credit Suisse (CS) 13
Crew 72

D
Daley, Richard M. 25
Daley, William M. 25
Danisco 42
DealFlow Media 58
Delaware North 47
Differential Research 36
Dijit 30
Dimon, Jamie 25, 37
DreamBots 30
Duke Energy (DUK) 42
Dun & Bradstreet (DNB) 48
DuPont (DD) 17, 42

E
eBay (EBAY) 14
Edison International (EIX) 21
Emanuel, Rahm 25
Envision Capital Mgmt. 40
ExxonMobil (XOM) 16

F
Facebook 48, 72
Fannie Mae (FNM) 39
50 Cent 30
Fluidigm 34
Forbes, Randy 27
Ford Motor (F) 22
Forrester Research (FORR) 30
Fotowatio Renewable Ventures 21
Freddie Mac (FRE) 39
Fresh Healthy Vending 45
Fritz 72
FrontPoint Partners 38

G
GameStop 28
Garmin (GRMN) 75
Geithner, Timothy 24
General Electric (GE) 17, 27, 64
General Motors (GM) 22, 69
Giffords, Gabrielle 50
Glock 50
Glock, Gaston 50
Goldman Sachs (GS) 14, 21, 38, 64
Google (GOOG) 24, 28, 48, 69
Gore, Al 25
Gorman, James P. 38
Graham Fisher 39
Great Hill Partners 48
Groupon 42
GYM Sportsbar 72

H
Home Depot (HD) 64
Hope Global 22
H&R Block Financial Advisors 40
HSBC (HBC) 9, 22
HudBay Minerals (HBM) 42
Hu, Jintao 27
Humana (HUM) 26
Human Healthy Vending 45

I
IBM (IBM) 25
iGate (IGTE) 42
Immelt, Jeffrey 27
IndiGo 21
Infosys (INFY) 13
International Game Technology (IGT) 20
ISI Pharmaceuticals (OSIP) 36

J
Jefferies Group (JEF) 36
Jobs, Steve 32
JPMorgan Chase (JPM) 25, 37, 74

K
Kawanda Industries 69
Kerrisdale Capital Management 58
Kim Eng Holdings 42
King, Brett 47
Kullman, Ellen 17
Kyocera (KYO) 19

L
Lady Gaga 30
Lava Records 18
Leap Wireless (LEAP) 19
Lear (LEA) 22
Lee, Hsien Loong 13
LG Electronics 30
Lowe's (LOW) 40, 64
Ludacris 30

M
Machulis, Kyle 28
Madoff, Bernie 37
Malayan Banking 42
McNerney, Jim 27
Merchant, Cheryl 22
MetroPCS Communications (PCS) 36
Microsoft (MSFT) 28, 30, 36
Montblanc 20
Moody's (MCO) 39
Morgan Stanley (MS) 14, 16, 38
Motorola (MOT) 30
Motorola Solutions (MSI) 27
MSPC Certified Public Accountants 58
Muddy Waters Research 58
Mugabe, Robert 11

N
Needham & Co. 36
Nellie's Sports Bar 72
NetList (NLST) 36
Newell Rubbermaid (NWL) 21
News Corp. (NWS) 18, 21
New York Knicks 72
Nielsen Holdings 42
Nomura Securities International (NMR) 19
Norsemont Mining 42
Nvidia (NVDA) 30

O
OAO Lukoil 16
Obama, Barack 24, 25
Occidental Petroleum (OXY) 16
Ogilvy & Mather 72
OMV 42
Oppenheimer (OPY) 38
Oppenheimer Main Street Small Cap Fund (OPMSX) 58
Orkla 42

P
Pan American Energy 16
Panasonic 30
Parmalat 37
Patni Computer Systems (PTI) 42
Pioneer Natural Resources (PXD) 42
PNC Bank 22
Polaroid 30
PowerShares Golden Dragon Halter USX China Portfolio 58
PrimeSense 28
Progress Energy (PGN) 42

Q
Qingdao Inter-Credit Services 58
Quicken (INTU) 47

R
Renaissance Financial 38
Rivers, Joan 78
Rivlin, Alice M. 24
Rochdale Securities 37
Roth Capital Partners 58
Royal Dutch Shell (RDS.A) 16
RSR Wholesale Guns 50

S
Samsung 69
Sanford C. Bernstein (AB) 64
Schaeffer's Investment Research 36
Schlafly Beer 47
Schwab (SCHW) 14
Score Bar 72
Seeking Alpha 58
Seidenberg, Ivan 32
Shine Group/Reveille 18
SideLines 72
Sig Sauer 50
Sifteo 30
Sirius XM Radio (SIRI) 20
Smart Robots 69
Smith & Wesson (SWHC) 50
Sodexo 45
Sony (SNE) 30
Southwest Airlines (LUV) 14
Sportsman's Warehouse 50
Sprint (S) 19, 31
Standard Chartered 9
State Grid 27
SunPower (SPWRA) 21
Syncrude Canada 16

T
T2 Partners 40
Tata Consultancy Svcs. 13
TCL 30
Tencent Holdings 21
thriXXX 28
Timberland (TBL) 22
Tomé, Carol B. 64
Toshiba 30
Total (TOT) 16
Tullow Oil 16
20th Century Fox (NWS) 30
Twitter 30, 47, 48

U
UBS (UBS) 20, 31
United Bank of Denver 64
UnitedHealth Group (UNH) 14, 26
United Parcel Service (UPS) 64

V
Vend Natural 45
Verizon Wireless 31, 32
Virgin Records 18
Vivendi 18

W
Wanxiang America 27
Water Island Capital 36
Web.com (WWWW) 48
Weingarten, Randi 80
WellPoint (WLP) 26
Wells Fargo (WFC) 14, 22, 37, 64
Willow Garage 28, 69
Witeck-Combs Communications 72
Woodside Petroleum 16
Woof's 72

X
Xerox (XRX) 50
Xi, Jinping 12

Y
Yahoo! (YHOO) 58
Yelp 48

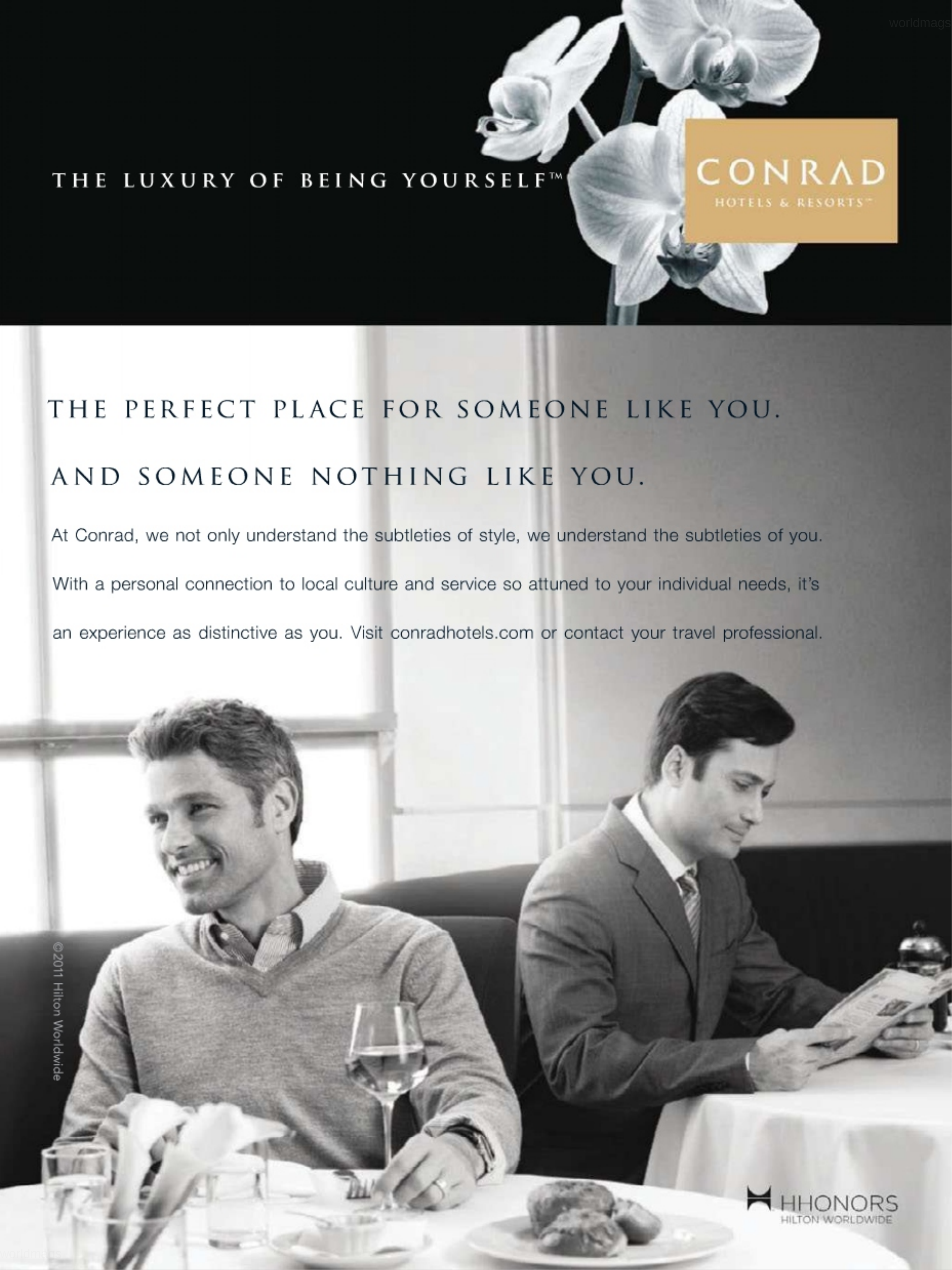
Z
Zandi, Mark 39

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Opening Remarks

Back to the Economic Future

John Maynard Keynes and Friedrich Hayek, who battled over the Depression, are getting a fresh look as the Long Slump lingers on. By Peter Coy



Economists, John Maynard Keynes wrote in 1931, should be more like dentists—"to get themselves thought of as humble, competent people." It's a goal more urgent than ever today, since economists, especially those who purport to understand the workings of the macroeconomy, have been kicked in the teeth during the past few years. Their intricate mathematical models largely failed to predict the 2008 financial crisis. Some economists have been assailed for having financial ties to the big banks that did so much to precipitate the crisis. And now they are divided about how to get out of the slump and worried that U.S. employment won't return to normal for years.

No wonder the annual meeting of the American Economic Assn. (AEA), held on Jan. 6-9 in Denver, was a scene of much soul-searching and little mirth. Keynes didn't speak to this point, but we can stipulate that dentists have more fun. The American Dental Assn.'s annual meeting is in Las Vegas; the AEA's top entertainer in Denver was "stand-up economist" Yoram Bauman, who teaches at the University of Washington and favors wisecracks about marginal utility.

As macroeconomists grope for new ideas to reinvigorate the profession, they're looking past the one-liners and harking back to the old masters. In Denver, Stanford University economist Robert E. Hall, concluding his one-year term as president of the AEA, introduced an economic model that leans heavily on Keynes' Depression-era insights about the ineffectiveness of central banks when interest rates hit zero. (The federal funds rate target has been stuck at 0 percent to 0.25 percent for two years.) Meanwhile, the liberal billionaire investor George Soros hosted a talk last year

on the economic theories of Keynes' archrival, Friedrich Hayek (1899-1992), a hero of the Tea Party movement. The profession is in such tumult that some thinkers are being to drawn to their ideological opposites.

The ferment calls to mind Thomas Kuhn's 1962 book *The Structure of Scientific Revolutions*, which posits that when one scientific paradigm breaks down and another hasn't yet taken its place, all hell breaks loose. In Denver, it was clear that the decades-long project to weave different strands of macroeconomic thought into a "neoclassical synthesis" had run into an intellectual cul-de-sac. But it was far from clear what new approach might emerge to replace it.

Economists can't even agree on whether they disagree. Hall, who also chairs the committee that dates the beginnings and ends of recessions, insists that disputes within the profession are a media concoction. "Modern macro doesn't have schools [of thought] anymore," he said at another session. "Only the press thinks it's interesting to talk about schools." Yet doors away, other economists were enthusiastically poking holes in the so-called consensus from the perspective of Minskyites, Austrians, Institutionalists, and on and on. John Quiggin of Australia's University of Queensland argued that the economic ideas most discredited by the crisis were those of the "sensible center of the profession"—such as Federal Reserve Chairman Ben Bernanke's mistaken assertion before becoming chairman that the U.S. economy had achieved an enduring "Great Moderation."

Bottom line: No consensus. But no dentist-like humility, either. "If you ask 1,000 economists what's wrong with economics," says Scott Sumner of Bentley University in Massachusetts, "they'll all tell you the same thing—which is that other economists don't believe what they believe." Benjamin M. Friedman, a Harvard University economist, said that many economists seem to be returning to theories that have been discredited. Says Friedman: "A large amount of the old complacency has crept back."

"Most of mainstream macroeconomics is dead. It's a zombie."
—L. Randall Wray, University of Missouri at Kansas City

The renewed investigations into the thinking of Keynes and Hayek may seem to signal that the profession hasn't advanced much in the past five decades. Yet it is heartening in a way, since it shows that at least some of today's economists are willing to reassess their theories in light of new data. Stanford's Hall, for instance, is a senior fellow of the free-market Hoover Institution, which is hardly a hotbed of belief in Keynes' bedrock notion of expanding government to solve economic problems. Still, Hall thinks Keynes was right that more government spending on infrastructure would boost economic growth. His objection is tactical, not theoretical. For whatever reason, Hall says, "government is incapable of executing a rapid and large increase in purchases."

Equally surprising is that Soros, the bane of the Tea Party, has taken an interest in Hayek, the author of the libertarian manifesto *The Road to Serfdom*. Last year the Institute for New Economic Thinking, which Soros launched in 2009 with a 10-year, $50 million pledge, invited one of the world's leading Hayek scholars, Bruce Caldwell of Duke University, to speak at its inaugural conference at King's College, Cambridge. (Caldwell is the editor of the new, definitive edition of *The Road to Serfdom*.)



Soros clearly doesn't share Hayek's politics, though both opposed communism. Still, in a video on the INET website, Soros praises Hayek for understanding that economics, unlike the hard sciences, cannot make strong predictions because its subjects (people) are so elusive. "Somehow, in the last 25 or more years, this has been forgotten, and I think it's time to remember it," Soros says.

The wisdom that's been lost since Hayek and Keynes engaged in friendly battle is that uncertainty is both unavoidable and potent. Errors in forecasting that lead to mismatches of savings and investment are crucial to both men's theories of booms and busts, albeit in different ways. The modern macro "synthesis"—now under repair—tended to give uncertainty only a bit part. Economist L. Randall Wray of the University of Missouri at Kansas City argues that "most of mainstream macroeconomics is dead. It's a zombie. They don't know they're dead yet, but they're dead."

To be fair, Wray's is an extreme view. There are a lot of smart economists who understand the field's problems and are working to fix them. Harvard's Friedman, despite his criticisms, says that in the past two years more economists have incorporated "credit-market frictions" into their models—in other words, they have finally acknowledged that not all consumers and businesses can borrow at reasonable rates at all times. Numerous sessions at the Denver conference were devoted to understanding the instability of the financial system. Harald Uhlig, chairman of the University of Chicago's economics department, who attended one of Soros' INET conferences, says groundbreaking work on financial failures and their consequences is being done by the likes of Xavier Gabaix of New York University's Stern School of Business, Roger E.A. Farmer of the University of California at Los Angeles, and Nobuhiro Kiyotaki of Princeton University.

The gloomiest forecast about economics is that the profession's progress will occur only funeral by funeral, as people entrenched in outdated thinking pass from the scene. But it doesn't have to be that way. For one thing, it's not just young people who are looking at things afresh—Hall, the outgoing AEA president, is 67. The newfound interest in the likes of Keynes and Hayek makes sense, too—their ideas were shaped by the Great Depression, which is the last time things were worse than they are now (for the U.S., anyway). That's why the newest thinking in economics is decades old. Ⓑ

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Global Economics



India
Its population is on track to exceed China's by 2028

AMIT BHARGAVA/BLOOMBERG

If Demography Is Destiny, Then India Has the Edge

▶ **Economists peer ahead and see population as a key factor**

▶ **"Developed countries will depend more than ever on creativity"**

What do Saudi Arabia, Egypt, Israel, Venezuela, and Malaysia have in common? Those five nations will experience the world's fastest growth in their working-age populations between 2010 and 2050, according to a new report by **HSBC**, the London-based bank. The next five on the list, which draws on U.N. projections, are India, Colombia, Argentina, Turkey, and Ireland.

In the present, it's an odd combination of economic stars and stumblers: Egypt still struggles with poverty, while Venezuela just devalued its currency. Ireland is practically a ward of the European Union. Yet if demography is destiny, as the 19th century French social scientist August Comte supposedly said, then all of these countries bear watching for big things in the coming four decades.

It's hard enough to predict gross domestic product a few quarters out. Undaunted, some economists are scanning the data for signs of the economic world order decades from now. The latest result is HSBC's Jan. 4 report, *The World in 2050*. After a period in which small, rich nations carried disproportionate clout, the dynamic is changing, according to HSBC. By 2050, says lead author Karen Ward, the bank's senior global economist, the emerging economies led by India and China will collectively be larger than the developed economies. Small European nations with low birthrates such as Austria, Belgium, Denmark, Norway, and Sweden will drop off the list of the 30 biggest economies.

HSBC's archrival, **Standard Chartered**, makes the same point in a November 2010 *Super-Cycle Report*, which looks ahead to the year 2030. The Standard Chartered authors foresee a return to historical norms for the world economy. In the year 1000, China and India together accounted for three-quarters of global output, according to estimates by economic historian Angus Maddison. China and India's combined share of output shrank to a puny 5 percent by 2000; it will rebound to 34 percent by 2030, estimates Standard Chartered. The U.S. share will decline from 31 percent in 2000 to 12 percent in 2030, Standard Chartered predicts.

Banks use scholarly reports such

China
The working-age population will begin to shrink after 2020

U.S.
The median age by 2030 will be 40, vs. 52 in Japan

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Global Economics



Cashing in on dead icons page 20 ▶

as these as calling cards for investment banking business, and the two banks' similar messages should go over well with their clients in emerging markets. Although both have headquarters in London, Standard Chartered gets 90 percent of its revenue from Asia, the Middle East, and Africa, while HSBC is the biggest bank in Hong Kong and the biggest international bank in mainland China.

Standard Chartered says the world has entered the third "super-cycle" of the Industrial Age. In the first, from 1870 to the eve of World War I, the U.S. grew into the world's biggest economy. The second, from the end of World War II through the early 1970s, witnessed Japan's ascendance to second place behind the U.S. In the third, which Standard Chartered says began in 2000 and has no end in sight, China will vault into first place with 24 percent of world GDP by 2030, twice the U.S. share.

While Standard Chartered is ebullient about prospects for emerging markets, HSBC is merely optimistic. Citing research by Harvard University economist Robert J. Barro, HSBC's Ward says that extrapolating from current investment rates in emerging markets "will tend to overstate growth." Investments hinge on the quality of human capital, Ward notes. "With the average person in China spending six years of life in education vs. 12 years in the U.S., that constrains how quickly labor productivity can catch up," she said in an interview.

The surprise winner is India, which despite its red tape, corruption, and inefficient politics will grow faster than China both per capita and in overall terms, both banks project. China's topline GDP growth will be inhibited by its one-child policy, which will cause its working-age population to shrink starting in the 2020s decade, says HSBC. India's working-age population will grow throughout the forecast period, the bank predicts, although not as rapidly as Saudi Arabia's, which the bank says will leap more than 70 percent from 2010 to 2050.

Using working-age population growth to predict the future has its limitations. Saudi Arabia even now suffers from widespread unemployment among its young. It will take a great effort to mold this youthful energy into a source of economic power.

Rich nations will grow more slowly than emerging ones, both banks say, because they generally have slower-growing populations. And they are already close to the leading edge of technology, so there are no easy leapfrog opportunities. Standard Chartered says that "the continuing success of developed countries will depend more than ever on creativity." As emerging markets become wealthier, their demand for the sophisticated goods and services produced by developed countries should grow, the bank says. That is, unless the emerging nations move so fast up the learning curve that they provide their own sophisticated goods and services. "It's a very tough question" how the U.S. and other rich countries will fare in the contest for high-end products, says economist David Mann of Standard Chartered.

Both banks conclude that strong global growth won't exhaust natural resources. HSBC cites an International Energy Agency scenario that says the price of oil could actually fall by 2050 if the world invests an extra $46 trillion in energy efficiency, renewables, nuclear, and "clean" coal. Standard Chartered expects the prices of oil and other commodities to rise–an investment opportunity, but not enough to choke off economic growth. —*Peter Coy*

The bottom line *21st century economic growth leaders will have fast-rising working-age populations. India will surpass China in population and growth.*

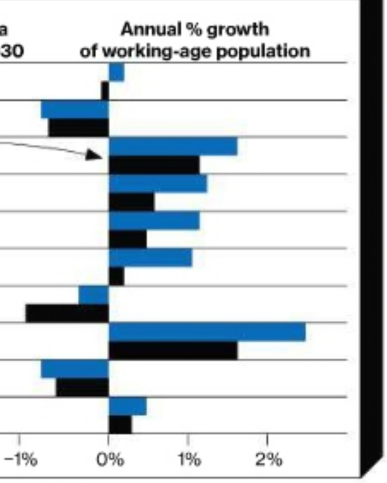
The Long View in Charts

New studies from HSBC, looking out to 2050, and Standard Chartered, forecasting to 2030, predict continued strong growth in output for emerging economies, including China and India. The share of global output for the U.S. and Europe will fall.

China on Top

Although China's growth rate is likely to slow from current levels, its output per capita will still expand 227% by 2030, HSBC predicts

Country	GDP per capita growth 2010-2030
China	227%
Russia	163%
India	130%
Indonesia	93%
Mexico	80%
Brazil	62%
Germany	53%
Saudi Arabia	52%
Japan	33%
U.S.	18%



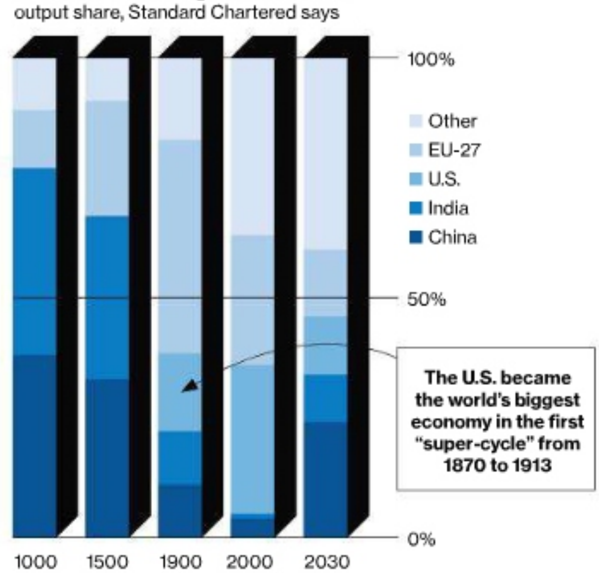
China will have the fastest growth in output per capita, HSBC predicts

But India, Indonesia, and Saudi Arabia, among others, will have faster growth in their working-age populations

DATA: U.N., HSBC, STANDARD CHARTERED, ANGUS MADDISON

A Thousand Years of World GDP

China and India will regain some of their output share, Standard Chartered says





President Mugabe: His party profits from diamond smuggling

Illicit Trade

Diamond Smuggling Thrives in Zimbabwe

▶ Stones flow from the Marange mines: Mugabe's party gets its cut

▶ "We must rein in the political elite ... prospering from the stones"

Enos Chikwere spills nine uncut diamonds from a bag at Restaurante Piscina in the town of Vila de Manica in Mozambique near the Zimbabwe border. He says the stones are worth $75,000 and that he bought them from Zimbabwean soldiers. The diamonds come from a mining concession the government seized in 2006 from a private company. The army has used forced labor, human-rights groups say, to mine the gems. The stones are sold illicitly via smuggling.

Chikwere is part of a chain that stretches back to the Zimbabwe African National Union-Patriotic Front (Zanu-PF), the party of President Robert Mugabe, which has won four violent and disputed elections since 2000.

The dealer says his gems come from Marange, Zimbabwe's biggest field, in in the east. By selling the army-sourced stones abroad, the dealers are enriching the 86-year-old President's party ahead of next year's vote, according to Human Rights Watch, Partnership Africa Canada, and the Movement for Democratic Change (MDC), the political party led by Prime Minister Morgan Tsvangirai that governs in a forced coalition with Zanu-PF. Extensive interviews with these human-rights groups, as well as MDC, smugglers, and diamond dealers, provided the information for this story. The human-rights groups in turn have based their assertions on interviews with soldiers, diplomats, diggers, community leaders, and members of government, including the Parliamentary portfolio committee on mines and energy.

Under Mugabe's policy of seizing farmland from white farmers and redistributing it to his followers, the once-prosperous Zimbabwean economy has shrunk drastically. Zanu-PF, in search of a steady source of financing, found it in the mines. "Revenue from the mines is serving to prop up Mugabe and his cronies," Tom Porteous, the U.K. director of New York-based Human Rights Watch, said in an e-mail to Bloomberg News on Dec. 8. "There are real concerns that diamond revenue will be used to fund political violence and intimidation of Mugabe's opponents." In previous political campaigns, Zanu-PF paid youth militia to beat up political opponents and intimidate voters.

The smuggling from Marange benefits Mugabe's party because it is mostly carried out through the military, which controls the mine and reports to Mugabe. Marange diamonds can't be exported legally because the field hasn't met an international certification standard showing that the proceeds don't go to finance conflict. Mozambique, meanwhile, isn't a member of the Kimberley Process, an organization of governments and diamond companies that tries to reduce the number of conflict diamonds in the world.

Mugabe's party denies the allegations of smuggling diamonds to support its campaign efforts. "These are just inventions of the Western imperialists who are trying to discredit Zanu-PF," spokesman Rugare Gumbo said in a Dec. 6 phone interview from Harare, the nation's capital. "There is no corruption at Marange, and Zanu-PF is not using the proceeds."

Soldiers mostly entrust the Marange stones to smugglers who then link up with buyers outside Zimbabwe. The MDC, the coalition partner that Mugabe reluctantly accepted into the government under pressure from other African countries, condemns the military's role. "We need the money to pay civil servants," says Finance Minister Tendai Biti, a member of the MDC. "We must rein in the political elite who are prospering from the stones."

The soldiers are very open in their trading, says a Nigerian dealer in Chimoio, capital of Mozambique's Manica province, who says his name is Colonel Rambo. They give their cut to their superior officers, who surrender a share to politicians, he says. In Vila de Manica, Chikwere boasts that there is no limit to the number of stones he can get. "Don't worry about me and the border," he says. "I have my systems."

—*Brian Latham and Fred Katerere*

***The bottom line** According to Human Rights Watch, the Zimbabwe military is selling diamonds illegally to finance Robert Mugabe's reelection campaign.*

Quoted

"Telling people you cannot beat the market is like telling a six-year-old that Santa Claus doesn't exist. The six-year-old doesn't want to believe it. Neither do people on Wall Street."

—Burton Malkiel, Princeton University professor of economics and author, *A Random Walk Down Wall Street*



CLOCKWISE FROM TOP LEFT: M. GARRETT/MURRAY GARRETT/GETTY IMAGES; KELD NAVNTOFT/AFP/GETTY IMAGES; AXEL GRIESCH/ASFM/GETTY IMAGES

Culture

China's Sentimental Journey Back to Mao

▶ Chongqing Party boss Bo Xilai revs up the nostalgia machine

▶ "Beijing cannot appoint people that the public won't support"



Bo Xilai is seeking a top Politburo post

Chongqing, a megalopolis best known for its industrial might and raw capitalism—think the Chicago of China—is fondly recalling its socialist past.

A local cable channel has just started running Mao-era revolutionary film epics with names like *Liberation of the Greater Southwest* and *Marching Forward for the New China*. Residents are being encouraged to sing "red" songs and send text messages promoting collectivist values. These songs sport catchy titles like *Ode to the Motherland* and *Without the Communist Party, There Would Be No New China*. The text messages are upbeat and don't echo the more provocative sentiments of Mao Zedong (remember "Political power grows out of the barrel of a gun"?). An excerpt from a recently coined online slogan: "It is difficult to work all day, so don't forget to wear extra in this cold weather!"

Do the Chinese of Chongqing really want to give up their Ford Fiestas and bootleg iPhones for a return to the Maoist era? "Ordinary Chinese and particularly those of lower incomes have a high appreciation for the Mao regime," says Li Shi, an economist at Beijing Normal University. "They remember a more equal society."

The red culture campaign isn't just a remembrance of things past. Bo Xilai, Chongqing's Party Secretary and China's former Commerce Minister, has launched this movement with a goal, say political analysts, to beef up his revolutionary bona fides with China's elder statesmen and broaden his appeal to ordinary Chinese who feel bruised by 30-plus years of modernization. If he succeeds, he may land a key seat in China's next government, which takes power shortly after the Communist Party Congress in the fall of 2012. "It's the season to determine the precise positions of the new leaders," says China strategist Robert L. Kuhn, author of *How China's Leaders Think*. "The ultimate power is on the Politburo Standing Committee—the nine slots at the top."

Bo, 61, is one of roughly 15 candidates vying for these positions, says Cheng Li, a political scientist who studies Chinese leadership politics for the Brookings Institution in Washington. Li says that while officially the standing committee is chosen by the 300-plus members of the Central Committee, in reality the current Standing Committee consults with a few retired political heavyweights before picking their successors behind closed doors.

What has changed in the last three or four years is the importance of public opinion in choosing the final candidates, say Brookings' Li and other analysts. "Beijing cannot appoint people that the public won't support. The storm of protest on the Internet would be embarrassing," says Kuhn.

The positions of Party Secretary/President (held by the same person) and Premier are almost certain to go to 57-year-old Vice-President Xi Jinping and 55-year-old Executive Vice-Premier Li Keqiang. Bo's prospect of landing one of the remaining jobs, perhaps as top official in charge of propaganda, look stronger since Xi voiced support for Bo's leadership of Chongqing during a Dec. 6-8 visit, according to Brookings' Li.

China's wannabe leaders can be divided into two camps. One faction is made up of those officials who rose to power through the Communist Youth League. President Hu Jintao hails from this group and so supports fellow League members such as Li Keqiang, says Li of Brookings. The second camp, which includes Bo and Xi Jinping, are the princelings, the well-connected children of former revolutionary leaders.

Princelings have a special need to burnish their red credentials. "Some people are critical of the princelings" and see them as using their positions to amass power and wealth, says Li. "Bo wants to send the message that princelings are the most reliable people to maintain Communist rule."

The campaign clearly strikes a chord in Chongqing. The older generations recall a tougher yet in some ways more secure era, says Zhang Jiedong, a 26-year-old recent graduate of the Sichuan Fine Arts Institute in Chongqing. There was less stress; income was guaranteed and competition for status symbols was almost nonexistent. Younger people are also inter-



"To read too many books is harmful." — Mao Zedong



ested in this period in China's history. Bo's crackdown on organized crime and corruption in Chongqing has been very popular. Says Zhang: "As long as the people are happy, that is most important." —*Dexter Roberts*

The bottom line *Nostalgia for the simpler comradeship of post-1949 China is taking off. An ambitious high party offical, Bo Xilai, is partly responsible.*

Labor Laws

In India, 101 Employees Pose Big Problems

▶ Companies with more than 100 workers need state approval to fire

▶ "Men's underwear? Why bother? ... I'd need thousands of employees"

Surrounded by humming sewing machines and gossiping women, Nazia Begum stitches a gauzy black frill onto a C-cup brassiere in a factory in Muzaffarpur, about three hours south of New Delhi. Her employer, Shekhar Bhagwat, matches the bra to a photograph to check the quality, then watches as the lingerie gets packed and sent off to a Paris boutique.

Although Bhagwat is prospering, he faces a dilemma. The next logical move is to branch out into men's underwear, yet margins are smaller in the men's line and a company requires big economies of scale to succeed. "Men's underwear?" asks Bhagwat. "Why bother with the headache? I'd need thousands of employees."

Ramping up does not appeal to businessmen like Bhagwat. As soon as a company hires more than 100 employees, it is impossible to fire anyone without government permission. Such laws have long deterred foreign investors, hampered manufacturing, and prevented the nation of more than 1 billion people from experiencing an industrial takeoff similar to China's. Now legislators are fighting to push a law through Parliament to let a company expand its workforce without surrendering the power to lay off workers to bureaucrats. The bill faces fierce opposition from labor unions.

India's labor laws have their roots in the British raj and were last fully updated in the Industrial Disputes Act of 1948. They prohibit companies with more than 100 employees from making positions redundant and firing people for any cause other than criminal misconduct. An additional 45 national laws intersect or derive from the 1948 act, and about 200 state laws control the relationships between employees and employers, according to India's Labor Ministry.

Companies must keep 6 attendance logs and 10 separate accounts for overtime wages, and file 5 types of annual returns. There are at least 11 definitions of the word "wage." Other rules regulate the height of urinals in workers' washrooms, how often a building must be lime-washed, and how many sand-filled buckets must be on hand to put out fires.

In a speech to trade unions on Nov. 23, Prime Minister Manmohan Singh wondered if these laws had hampered India's growth. "Is it possible that our best intentions for labor are not actually met by laws that sound progressive on paper but end up hurting the very workers they are meant to protect?" he asked. India could have added 2.8 million jobs to the formal economy in the decade through 2007 had labor laws been less restrictive, the World Bank said in 2007. As few as 30 million Indians work in the formal private sector or government, according to the Central Statistical Organization,

➜

Talking Points
Lee Hsien Loong

Singapore's strong growth and efficient government have earned its leaders a voice that others listen to. Prime Minister Lee Hsien Loong looks ahead

On China and the U.S.
The most consequential relationship in the world today is between the U.S. and China. There has been friction, notably over exchange rates. But from an economic point of view, this needn't be a win-lose battle. A gradually appreciating yuan will encourage Chinese export industries to restructure and upgrade, help distribute the gains from growth more broadly beyond exports to the rest of the economy, and mitigate inflation, which is a growing problem. At the same time, a stronger yuan will help ease political pressures in the U.S. and defuse tensions in the relationship.

On China's power
The Chinese are aware of foreign perceptions that with growing strength it has become more assertive. China's leaders have emphasized that the country is committed to peaceful development. No less than the U.S. or other democracies, China has its own domestic politics that it can't ignore. China's leaders need to explain this reality, and their basic thinking, convincingly to international audiences.

On Globalization
Competition is intense, change is continuous, and the fruits of prosperity are unevenly distributed. The only reliable strategy is for countries to upgrade the skills of their people and the capabilities of their economies. This means educating the population, investing in technology and infrastructure to raise productivity, developing new industries to replace declining ones, and constantly adapting to stay relevant. This is what Singapore is striving to do. Ⓑ

FROM TOP: COWB/IMAGINECHINA; CHARLINEX CHINA COLLECTION/ALAMY

worldmags

the government statistics group. (The rest work in agriculture or the underground economy.) Credit Suisse economist Robert Prior-Wandesforde calls this number "absurdly low." China has at least 260 million workers in manufacturing, mining, and nonfarming activities, according to International Labor Organization estimates. "It's unusual how successful India has been without any sort of industrial revolution," says Prior-Wandesforde, head of South East Asia and India Economics at Credit Suisse.

India's IT companies, such as **Tata Consultancy Services** and **Infosys**, employ as many as 2.7 million. Some labor laws were waived starting in 2001 to encourage growth in the sector, India's second-largest earner of foreign exchange, by placing most of the workforce inside fenced-off zones. The waivers allowed IT companies and call centers to operate 24 hours a day, recruit women to work late at night without building single-gender facilities, and add staff freely without submitting layoff decisions to the authorities.

30
MILLION

Indians working in the formal economy, vs. 260 million in China

The success of the Software Technologies Parks of India Act—and of special economic zones in China—has spurred the revival of a 45-year-old plan that creates special enclaves with more infrastructure and fewer labor laws. Other companies hire professionals on three-year contracts and laborers on daily wage contracts, says K.R. Shyam Sundar, an industrial relations expert who has worked with Indian universities. Contracted labor can be fired more easily.

Without reform, there will be fewer opportunities for Indians such as Begum, who is raising two children on the $3.80 she is paid for 10 hours of work a day in the lingerie factory. Her income puts her in the top 20 percent of wage earners, according to the National Commission for Enterprises in the Unorganized Sector. "This job keeps me from begging," she says.

—*Mehul Srivastava*

The bottom line *India's labor laws deter businesses from hiring more than 100 workers and are holding back the country's industrial growth.*

Seven Days

Events of note in the week ahead

by Ira Boudway

17

Euro zone finance ministers meet in Brussels

Hong Kong Fashion Week begins



▶ **Martin Luther King Jr. Day:** Markets closed in the U.S.

▶ **Dodd-Frank deadline:** The Securities and Exchange Commission reports on which agency should regulate financial advisers.

18

China Internet Industry annual conference in Beijing

Earnings from Citigroup and Charles Schwab

▶ **Apple earnings:** The tech juggernaut passed PetroChina earlier this month to become the second-largest company in the world by market cap.

19

London Art Fair opens

Earnings from eBay, Goldman Sachs, and Wells Fargo

▶ **Obama hosts Hu:** China's President makes a state visit to the White House. U.S. Defense Secretary Robert Gates met with Hu on Jan. 10 to discuss military relations.



20

Philadelphia Fed Business Outlook Survey

Earnings from Google, Morgan Stanley, Southwest Airlines, and UnitedHealth Group

▶ **U.S. existing home sales:** Analysts expect a 4.84 million annual rate for December as the housing market slowly climbs back from a low of 3.84 million in July.



21

France's Leading Economic Index

General Electric earnings

▶ **Bank of America earnings:** Analysts expect revenues of $25.3 billion for the quarter, down slightly from last year. The largest U.S. bank is bracing for possible disclosures from WikiLeaks.

22

Evander Holyfield, 48, fights Sherman "The Tank" Williams in West Virginia



▶ **U.S. soccer:** The men's national team opens the new year with an exhibition match against Chile at the Home Depot Center in Carson, Calif.



23

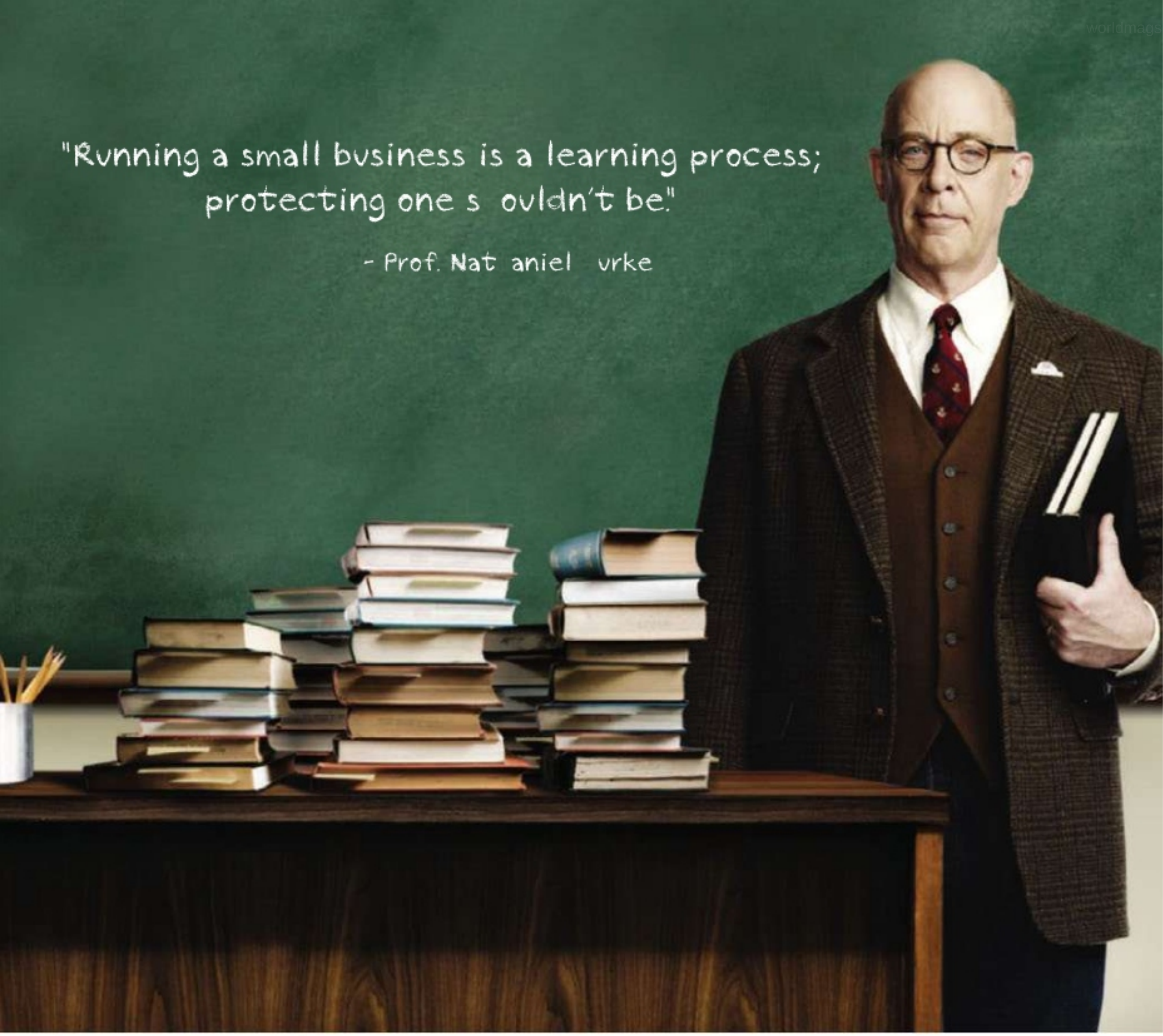
NFL conference championships

▶ **Presidential election in Portugal:** The incumbent, Cavaco Silva of the Social Democratic Party, leads in the polls.



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As a small business owner, you have enough on your mind without having to worry about what happens to your business if disaster strikes. Farmers agents have been trained to help you find coverage that fits your business and your bottom line. They learn these skills at the University of Farmers; an educational institution whose humble mission is to produce insurance agents of the very highest caliber. Talk to a local Farmers agent and learn how you can protect your business in the event of a disaster, an accident, or a workers' compensation claim. To find an agent near you, go to farmers.com or call toll free 1-866-200-4BIZ (4249).

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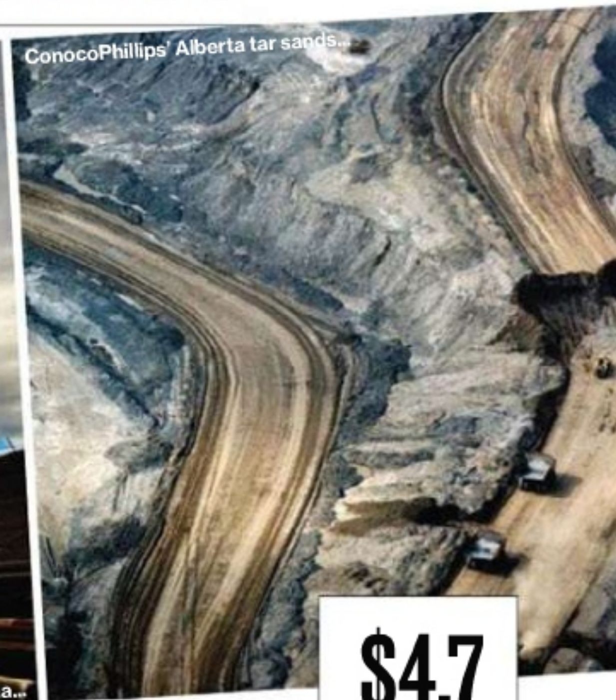
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Contents ▶ **DuPont: Taking cues from its past** 17 ▶ **Universal Music hopes for a buzz from *American Idol*** 18 ▶ **How cell providers are making money from free wireless service for the poor** 19 ▶ **Marilyn's marketing comeback** 20 ▶ **Briefs** 21 ● **Edited by James E. Ellis**

$7.0 BILLION


Sold: BP fields in Argentina...


ConocoPhillips' Alberta tar sands...

$4.7 BILLION

Global Oil Companies Discover Cash in Their Trash

▶ Companies like BP and Shell fetch top prices for assets many thought they'd struggle to discard

▶ "They are not getting any value in the stock market for having these assets around."

To pay tens of billions of dollars in costs from the Deepwater Horizon disaster and spill, **BP** has been forced to ditch oil fields and other energy properties across the globe. Far from the predicted fire-sale, BP's housecleaning has been a huge success. It has brought in $22 billion so far, fetching double the values on BP's books for some assets. Now other companies including **Royal Dutch Shell** and **ExxonMobil**, which sold nine of its Gulf of Mexico fields for about $1 billion last year, are also making divestitures of their less-attractive assets.

Asset sales by the world's oil majors exceeded $50 billion last year, the most in at least 12 years. It's not over. Jerry Kepes, a partner at consultants PFC Energy, estimates the oil majors have $150 billion to $200 billion worth of properties on their books that they could sell without an appreciable negative impact on their current performance or long-term outlook. "They are not getting any value in the stock market for having these assets around," he says.

The sales are being prompted by several factors, including an abundance of buyers, stable oil prices that make deals easier, and a continuing shortage of the skilled staff needed to develop and operate oil fields. The most important factor may be a kind of identity crisis the big companies are struggling through. The markets used to reward the majors with higher share prices than their smaller competitors. No longer. Investors today see these companies as unwieldy conglomerates with little potential for growth. "There has been deep skepticism that the supermajor model adds value," says Theepan Jothilingam, an oil analyst at Morgan Stanley in London.

Over the last five years, stocks of the six largest Western oil companies–ExxonMobil, Shell, BP, **Total**, **Chevron**, and **ConocoPhillips**–have logged an average annual return of just 5 percent. That's considerably less than the 8.3 percent returned by an index of smaller oil companies, including **Anadarko Petroleum** and **Apache**, and downright puny compared with the rocket-propelled performance of some smaller exploration companies such as Africa specialist **Tullow Oil**, which averaged 38 percent. Crude oil itself was a better investment than the majors, returning 9 percent.

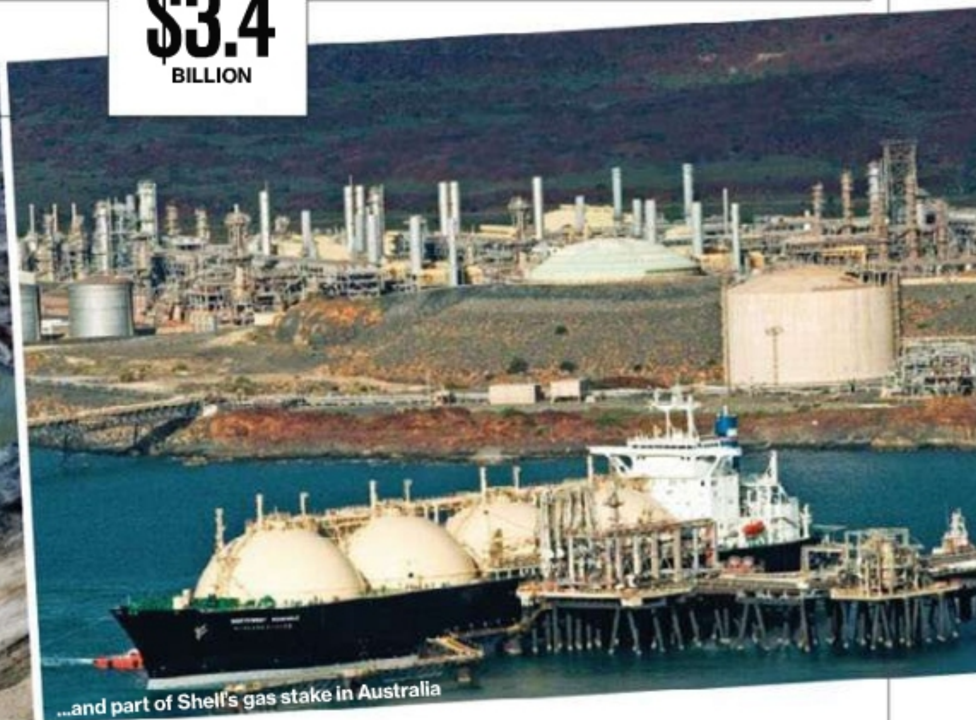
The energy giants are beginning to get the message. They're putting low-growth or marginal businesses on the block to raise money to plow into exploration, liquefied natural gas, and deepwater drilling activities that bring higher risks along with the possibility of better returns.

FROM LEFT: PAN AMERICAN ENERGY; LARRY MACDOUGAL/CANADIAN PRESS/AP; WOODSIDE PETROLEUM LTD/REUTERS

worldmags

$3.4
BILLION





...and part of Shell's gas stake in Australia

Shell has turned more aggressive under new Chief Executive Peter Voser. The company has already exceeded a target of $8 billion in divestments. Among the highlights: the sale of a 10 percent stake in Australia's **Woodside Petroleum** for $3.35 billion and a sale of Texas gas fields to **Occidental Petroleum** for $1.8 billion.

Shell needs capital for what may turn out to be as much as $50 billion in new Australian gas projects as well as a huge $19 billion plant in Qatar that converts natural gas to diesel and jet fuel. "The divestments are in areas where we either see limited growth potential or other people may be prepared to invest more," says Chief Financial Officer Simon Henry.

Another big seller is ConocoPhillips, the No. 3 U.S. oil company, whose CEO James J. Mulva announced in 2009 that he wanted "a reduced but more strategic" portfolio. Minority stakes with little control were deemed expendable. Last year, Mulva sold Conoco's 9 percent stake in **Syncrude Canada**, a tar sands venture, to **China Petrochemical** for $4.65 billion. The company is also jettisoning its 20 percent stake in Russia's **OAO Lukoil** for about $9 billion. "I think they've realized they don't need to compete with Chevron and Exxon in terms of size," says Brian Youngberg, an analyst at Edward Jones.

There's been no shortage of buyers. Occidental and Apache, midsized operators skilled at squeezing oil out of old fields, are both believed to have competed for BP's first big sale of mature North American and Egyptian fields. (Occidental declined comment.) Apache prevailed, agreeing in July to pay $7 billion, a rich price. Buyers from energy-hungry developing nations like China have also joined the fray. In November, China's **CNOOC** and Argentina's Bulgheroni family bought BP's 60 percent stake in **Pan American Energy** for $7 billion. The sale followed the pattern of other BP sales: Pan American was a low-growth property too distant from other BP holdings to offer economies of scale.

Consultant PFC Energy says that none of BP's sales will affect the three big bets the company is making for its future: deepwater drilling in the Gulf of Mexico and Angola; complex gas projects like BP's big plants in Trinidad; and massive oil projects such as in Azerbaijan. When he took over in July, Robert Dudley, BP's new CEO, said that a silver lining of the Gulf of Mexico mess was that BP could wind up a slimmer company with "higher-quality assets and growth." What sounded like happy talk then now seems prescient. — *Stanley Reed, Brian Swint, and Edward Klump*

Energy-hungry China is snapping up far-flung properties from Canada to Argentina

The bottom line *Major global oil companies are unloading low-growth energy assets. They're getting surprisingly rich prices in return.*

Chemicals

A DuPont Chief's Days of Future Passed

- Like her predecessors 100 years ago, Kullman bets on technology
- "I'm thinking ... biotechnology—there could be some parallels"

DuPont Chief Executive Officer Ellen J. Kullman prepared for a deal that could redefine her company's future by studying its distant past. Kullman found inspiration in two out-of-print books that recount how three du Pont cousins took control of the gunpowder maker in 1902 and diversified into plastics and synthetic fibers, risky emerging technologies in those days. "I'm thinking, industrial biotechnology—there could be some parallels there," Kullman told Bloomberg in late December.

Less than three weeks later, Kullman on Jan. 9 struck a $5.8 billion deal to buy **Danisco**, a Danish company that uses biotechology to develop industrial enzymes that are catalysts used to make ethanol, food, animal feed, and textiles. The acquisition will make DuPont, already the world's largest car-paint maker and the second-biggest seed supplier, the No. 1 producer of food additives and the second-largest maker of enzymes used to make biofuels.

Kullman, 54, took DuPont's helm two years ago. She is convinced the chemical maker's best growth opportunities lie in capitalizing on market challenges stemming from the steady growth in global population: improving agricultural productivity, finding cleaner energy sources, and protecting the environment. "We are well aligned with these megatrends in the area of increasing the quantity and quality of food and decreasing dependency on fossil fuels," she says.

Danisco's product lines fit nicely with that strategy—one reason DuPont was willing to pay a 25 percent premium above the company's pre-deal stock price. The two companies already have a 50-50 ethanol joint venture, which in December 2009 opened a $50 million demonstration plant in Vonore, Tenn. It can make 250,000 gallons a year from corn cobs and switchgrass. The companies plan to open a U.S. plant in 2013 to make up to 50 million gallons of ethanol a year from corn cobs. A subsequent plant will produce commercial quantities of ethanol from switchgrass.

Kullman sees demand for biologically derived materials like those made by Danisco taking off the same way as sales of solar-panel parts, another DuPont line. "We have been in industrial biotechnology for 10, 15 years already, and so we are coming up that curve," she said. "There will be a tipping point."

When Kullman became CEO, some on Wall Street doubted whether DuPont could have predictable growth while it quickly adapted to newer technologies. Kullman won their trust when she successfully steered DuPont through the recession and delivered seven straight quarterly earnings that beat analysts' expectations. She slashed more than $1 billion in annual costs in her first year, froze capital spending, and eliminated all group vice-president jobs. Approving investors pushed up DuPont's shares 48 percent in 2010, an increase topped only by **Caterpillar** among companies in the Dow Jones industrial average. "It's pretty remarkable," says Richard Vanden Boogard, an analyst at Victory Capital. "The Street believes them now."

The first woman to lead 208-year-old DuPont, Kullman says her experience as a parent helped her instill the discipline needed to bring her company through the recession. Kullman said she centered fearful employees by having them focus on what they could control, whether that was customers or costs or inventories. "I am a much better leader because I had three kids," she said. "With kids, they don't do what you want them to do when you want them to do it. Organizations don't necessarily, either. You've got to listen. You've got to learn how to influence."

Kullman's influences include Jack Welch, the former **General Electric** CEO, whom she observed as a freshly minted MBA while working as what she calls a "bag carrier" for Edward E. Hood Jr., then GE's vice-chairman. Welch's use of data to drive decisions and hold executives accountable rubbed off, Kullman said. "He would remember what that business leader told him last year, and he would hold that business leader accountable," she saysa. "It was, 'Say what you are going to do, and then do it.'"

Kullman went on to sell CT scanners at GE before leaving to join DuPont's medical imaging unit in 1988. She's been there ever since, along the way managing a wide range of DuPont businesses from pigments to safety and protection fabrics like Kevlar.

"Ellen was underestimated because everyone thought, 'It's just another 20-year DuPonter, what's going to change?'" says Don Carson, an analyst at Susquehanna Financial. "Ellen has brought a whole different degree of accountability there." —*Jack Kaskey*

The bottom line *DuPont CEO Ellen Kullman is steering the company beyond traditional chemicals toward tech-driven food and biofuel ingredients.*



Entertainment

Universal Casts Its Vote On *American Idol*

▶ The music giant hopes its heft will boost TV's hit music competition

▶ "*Idol* has Super Bowl ratings every week. What else could...compare?"

American Idol has been the nation's most popular prime-time TV program for seven years running. As the aging franchise prepares to begin its 10th season on Jan. 19 in a crowded field of reality competition shows, *Idol* is getting a little help from a music industry friend: **Universal Music Group**. After replacing **Sony** as the singing competition's record-label partner in August, the world's biggest music company is intent on expanding its role beyond producing albums by finalists. The two new judges on the show are Universal artists Jennifer Lopez and Steven Tyler. Jimmy Iovine, founder of Universal's Interscope Records and the man credited with discovering big acts like Eminem, will coach contestants.

"It's a show that needs work, we all know that, but the concept is great," says Iovine. "This is about making the music better and making these kids really grow as artists."

The moves are part of an effort to restore *Idol*'s waning musical clout, promote the acts, and drive sales. Lee DeWyze, last season's champion, has sold 132,000 copies of his first album, a fraction of the 7 million logged by Carrie Underwood, winner of *Idol* season four, according to data from Nielsen SoundScan. After a 9 percent drop in 18- to 49-year-old viewers last season, and the departure of judge Simon Cowell to start a U.S. version of global music competition show *The X Factor*, **News Corp.**'s Fox and *Idol* producer FremantleMedia, owned by **CKx**, are placing a higher priority on the show's music.

Since its debut, *Idol* has become a force behind U.S. music sales and has created stars including Underwood and Kelly Clarkson. "It's still the most amazing marketing juggernaut in music history," says Lava Records President Jason Flom, former head of Atlantic Records, Virgin Records, and **Capitol Music Group**. "You'd have to go back to Ed Sul-

ILLUSTRATION BY ALEX EBEN MEYER; IOVINE: PAUL REDMOND/WIREIMAGE/GETTY IMAGES



livan and the power of early television to find anything close to its influence."

Lucian Grainge, the new chief executive of Universal Music, pushed to win the *Idol* contract to expand Universal's presence in product licensing, merchandising, and talent management. The label aims to boost sales of *Idol* albums by releasing CDs by the winners and runners-up two to three months after the show ends, half the time it previously took. Individual performances from the show will be sold on **Apple**'s iTunes and other digital outlets soon after an episode airs, Iovine says. Universal's Bravado merchandising group is also in talks with *Idol*'s producers to license products such as T-shirts, according to a person with knowledge of the discussions. Grainge declined to comment.

Universal will encourage contestants to sing songs by its recording artists, who include Lady Gaga, Bon Jovi, and Justin Beiber. That could renew interest in them similar to how Fox's hit series *Glee* has rekindled interest in bands including Journey, whose *Greatest Hits* album has ranked among top-sellers on iTunes since its song *Don't Stop Believin'* was performed by the program's youthful cast.

Idol contestants will work with Iovine and a cadre of top Interscope music producers including Timbaland, Ron Fair, Rodney Jerkins, and Alex Da Kid for three days each week they participate in the show. Iovine says he will also help with song choices and arrangements. He's ditching episodes in which all the contestants perform selections from a single artist or genre. "It's going to be more original," Iovine says. "I don't want them to be karaoke singers."

As *Idol* tests its new look, the show will face plenty of new reality series competitors. Elisabeth Murdoch's Shine Group/Reveille is producing *Live to Dance*, a new **CBS** series starring former *Idol* judge Paula Abdul. Murdoch's dad, Rupert, controls Fox.

Universal's tie-up is no slam dunk. U.S. album sales fell by 13 percent in 2010, the ninth drop in 10 years, according to Nielsen SoundScan. Total music sales, including digital tracks, music videos, and other categories, fell 2.4 percent. Grainge, meanwhile, is working to cut costs and shed jobs at Universal Music, a unit of France's **Vivendi**. Including merger-related write-offs, Universal Music showed a 2009 loss of 325 million euros ($427 million) before interest and income taxes, according to Vivendi's 2009 annual report.



"It's a show that needs work, but the concept is great," says Jimmy Iovine

Still, *Idol*, with a total audience that averaged more than 24 million viewers a night last year, gives Universal an unparalleled opportunity to break new acts, says Lava Records' Flom, who has signed artists including Twisted Sister and Tori Amos. "Idol has Super Bowl ratings every week," he said. "What else could possibly compare to that?"

—*Andy Fixmer, with Cliff Edwards*

The bottom line *Universal Music Group hopes to ride the coattails of TV ratings champ American Idol in a bid to grab new acts and music sales.*

Telecommunications

Wireless Riches from Serving the Poor

▸ Free cell phone services are booming, thanks to Uncle Sam

▸ "There's a growth opportunity here. There's an untapped market still."

While there's no free lunch, Evan Mensch recently discovered that there are free cell phones. After losing his sales job, the 37-year-old single father of two from Perry, Md., couldn't afford to continue his regular wireless contract. After learning of the federal program that provides wireless service to the oft-unemployed poor, Mensch signed up for a free **Kyocera** cell phone with 250 free minutes of calling a month through **Assurance Wireless**, a brand run by **Sprint Nextel**. "Because of Assurance, I was able to get a call back from an employer," says Mensch, who received a job offer in November after nearly two years without a job.

Sprint Nextel isn't driven by altruism. Serving cash-pinched customers like Mensch can pay off due to federal government subsidies. And finding new customers isn't hard. With unemployment at 9.4 percent and one in six Americans living in poverty, Sprint and rival **América Movíl**'s TracFone unit have seen an explosion in sign-ups for the government-subsidized free wireless services they've offered for more than a year. In some financial reporting periods, Assurance accounts for up to 60 percent of new subscribers to Sprint's prepaid cellular plans, which don't require an annual contract, estimates Michael McCormack, an analyst with Nomura Securities International. "There's a growth opportunity here," he says. "There's an untapped market still."

That's rare in the U.S., where more than 80 percent of adults already own a cell phone. American carriers in recent years have aggressively courted less saturated niches like youth, seniors, Spanish speakers, and even sports fans in search of subscriber growth. Now the poor or unemployed form a large pool of would-be customers. Successful applicants have to be eligible for Medicaid or several other low-income assistance



Bill Daley steps into the fray page 25 ▶

programs, have a family income significantly below the local poverty level (poverty guidelines vary by state), or receive food stamps. In October, 43.2 million received such food assistance, up 14.7 percent from a year earlier. Some 30 million households may qualify for the free service in just the 19 states where Assurance operates, says Grace Boehm, Sprint Nextel's director of Assurance Wireless. "As we see growth in the food stamp program, we tend to see an increase in the number of SafeLink subscribers," says Jose Fuentes, director of government relations at TracFone, about its free SafeLink Wireless brand, another big player.

$1.2 BILLION

Federal subsidy for low-income phone services in 2010

The Universal Service Administrative Co. (USAC)—which manages a federal fund to which U.S. telecom companies are required to contribute fees—pays carriers up to $10 per subscriber per month. While that amount may sound meager, it translates into roughly the same per-minute rate spent by the average paying U.S. wireless user. Meanwhile, Sprint's costs of recruiting and keeping these customers are likely lower: Although more than half of regular prepaid wireless subscribers drop their service every year, Assurance users stay put. "We've seen very, very low churn," Boehm says.

Until 2008 the government simply subsidized between $3 and $10 of qualifying low-income consumers' monthly wireless bills as a way to assure their access to basic phone service; customers paid the rest out of pocket. (Uncle Sam offers similar subsidies for landline customers.) But since TracFone started offering totally free service in August 2008, paid directly by the subsidy, demand has soared. USAC's annual disbursements to telcos providing low-income phone service rose 52 percent, to $1.25 billion, between 2008 and 2010. Free wireless is the biggest reason for the increase, with the new market generating hundreds of millions of dollars for service providers.

A staffer at the Federal Communications Commision, which oversees carriers, says the agency may consider tightening oversight and cost management of the fast-growing program. Still, agencies that promote the free phones see growth continuing. "Anytime the boss tells you not to come back to work, the home phone is the first to go," says Sharon Goodson, executive director of North Carolina Community Action Assn., which has helped thousands apply for Assurance phones.

Free cellular plans continue to spread across the map. In January, Sprint began offering Assurance service in five more states, and it hopes eventually to serve the entire country. Rival TracFone now offers its SafeLink Wireless service in 30 states, as well as in Washington and Puerto Rico. It has applied to provide the service in six more states. A dozen other carriers have recently applied for or received governmental approvals to offer free service. —*Olga Kharif*

The bottom line *Wireless operators like Sprint Nextel are building a big business providing free cellular service to the poor. Washington picks up the tab.*

Marketing

In Death, Endorsements Are a Girl's Best Friend

▶ The sale of Marilyn Monroe's name shows how dead celebrities live on

▶ "In the 21st century, that wall's disappeared" between star and fan

She's the ultimate celebrity, a luminous blond with international name recognition. Her new handlers are keen to build a reality show around her. And if the pieces fall into place, her name may soon grace a line of makeup and lingerie. That's a pretty good trick for a woman who died almost 50 years ago.

Marilyn Monroe, the rights to whose image and name were sold on Dec. 30, is just the latest departed star to launch a new career. Deceased stars or their estates generated $2.25 billion in North American revenue in 2009, says Ira Mayer, who runs *The Licensing Letter*, which tracks licensing deals. "The interest in dead celebrities by brands is growing because it's a known quantity," said David Reeder, vice-president at GreenLight, a **Corbis** unit that represents the estates of Steve McQueen, Johnny Cash, and Andy Warhol. "There's a lot of private equity money looking to buy entertainment properties."

McQueen appears in **UBS**'s *We Will Not Rest* TV ads, celebrating achievers. John Lennon has deals with Montblanc and **Citröen**. In 2010, **Fender Musical Instruments** spon-



Marilyn Monroe
New owners of the blonde bombshell's brand are pursuing a makeup line, lingerie, and a reality show

Marketing Immortals

Hawking the brands of dead celebrities has become a $2.25 billion annual business in North America. Here's a sampling of stars whose fame continues to generate revenues from beyond the grave.



John Lennon

In October, Montblanc released the $27,000 John Lennon Limited Edition 70 pen celebrating the late Beatle's 70th birthday



Jimi Hendrix

Hendrix's estate has battled relatives over products deemed inappropriate, including vodka co-marketed by a half-brother



Steve McQueen

Besides appearing in a UBS commercial, the action star has shown up on Dolce & Gabbana t-shirts and in a Tommy Hilfiger ad campaign



Elvis Presley

CKx, co-owner of Elvis Presley Enterprises, has struck deals with a comics publisher, Sirius XM Radio, and Cirque du Soleil



Bob Marley

The reggae legend lives on in the House of Marley line of headphones and Mellow Mood drinks sold in cans decked in island colors

sored the "Experience Hendrix" tour of artists performing music of guitar great Jimi Hendrix.

CKx, producer of *American Idol*, holds 85 percent of a venture that controls the Elvis Presley estate. "The family felt they had taken the brand as far as they could," says Chief Executive Officer Mike Ferrel. CKx has since signed with **Sirius XM Radio** for an Elvis channel, just inked a deal with Liquid Comics to develop an Elvis character, and expanded the relationship with **International Game Technology** for Elvis slot machines.

Jamie Salter, whose **Authentic Brands Group** paid an undisclosed sum for the rights to Marilyn Monroe's name, with entertainment licensing company **Neca**, got into the celebrity legacy game in 2009 when he and his former employer, Hilco Consumer Capital, teamed with the estate of Bob Marley to sell merchandise under the name of the late reggae singer. They've since launched a line of headphones under the House of Marley brand as well as a "relaxation drink."

Last year Salter launched Authentic Brands, backed by investment firm **Leonard Green & Partners**. He says the screen goddess' likeness was an obvious purchase for the venture. "Every female celebrity after Marilyn Monroe has tried to emulate her in some way," Salter says. "Marilyn Monroe is the brand." Under the deal, Salter's group is part owner of the rights to Monroe trademarks, including images of her lips, eyes, and the name "Marilyn Monroe"–but not the famous billowing dress publicity photo for the film *The Seven Year Itch*. Salter and Joel Weinshanker, president of Neca, say they're talking to retailers about selling lingerie and cosmetics under the Monroe name and shopping a reality TV show where contestants compete to represent the Monroe brand.

Although Monroe would be 84 today, Weinshanker says social media links younger audiences to celebrities of yore. "There always used to be a wall between a star and a fan," he says. "In the 21st century, that wall's disappeared." One sign: Monroe's Facebook page–and her 357,410 friends. —*Jonathan Keehner and Lauren Coleman-Lochner*

The bottom line *Marilyn Monroe is just the latest dead celebrity whose brand is being resurrected by marketers.*

OPPOSITE PAGE, CLOCKWISE FROM TOP: TIM BOYLE/BLOOMBERG; HULTON-DEUTSCH COLLECTION/CORBIS; MICHAEL OCHS ARCHIVES/GETTY IMAGES (2); WARNER BROS/GETTY IMAGES; JAN PERSSON/REDFERNS/GETTY IMAGES; POPPERFOTO/GETTY IMAGES. THIS PAGE, FROM TOP: NELSON CHING/BLOOMBERG; CHIP CHIPMAN/BLOOMBERG; MATTHIAS RIETSCHEL/APN PHOTO/AP

Briefs

by Caroline Winter



Baidu
An offering for English speakers

Baidu, China's largest search engine with about 70 percent of the market, has launched an English-language blog called Baidu Beat. The blog gives readers overseas a window into the interests of China's Internet users, as derived from search statistics. Users of Baidu Beat can send feedback, though they won't be allowed to post comments directly to the blog. Baidu and other Chinese Net companies are expanding globally after dominating their home market. Tencent Holdings, which has 637 million user accounts for its flagship QQ instant messaging program, in December said it will offer the service in English, Japanese, and French.

Edison International
More solar for California



Southern California Edison signed contracts with SunPower and Fotowatio Renewable Ventures to build seven solar power plants, one of which will be among the largest solar photovoltaic installations in the U.S. The new facilities, slated to open by 2016, will be built in Kern, Los Angeles, and Merced counties. They will provide 831 megawatts, enough to power about 460,000 homes. The bigger deal went to SunPower, which will build three plants with total capacity of 711 MW. Terms of the contracts weren't disclosed.

Goldman Sachs
Opening the kimono (a bit)

Goldman Sachs on Jan. 11 said it will disclose more information about its finances. The firm's plans were outlined in a report by a committee of employees formed after U.S. regulators sued the firm for fraud last year. The changes, to be adopted after Jan. 19, include reporting revenue in four categories instead of three and presenting a simplified balance sheet showing assets by business unit and activity. The new reporting system will separate the revenue and profit the firm makes trading with its own money from what it earns from trades on behalf of clients. Goldman also plans to offer more information on credit risk, operational risk, and capital adequacy.

Myspace
A social network for sale?

Myspace is cutting 47 percent of its staff, about 500 jobs, as owner News Corp. prepares for a possible sale, merger, or spinoff of the social-networking site, according to spokeswomen from both companies. The job cuts, disclosed in a statement from Myspace CEO Mike Jones, reflect the company's redirection of the site to help users discover music and videos rather than connect with each other. Myspace has seen an uptick in new and returning users since a late-October redesign, with over 3.3 million new profiles created and a 4 percent increase in mobile users between November and December. Cuts in 2009 reduced Myspace staff by 30 percent.

Airbus
The biggest jet order ever

Indian carrier IndiGo has signed a preliminary agreement to buy 180 Airbus A320s in what the manufacturer says is the largest jet order in aviation history. Valued at more than $15 billion, the order includes 150 A320s, upgraded with more fuel-efficient engines, to be delivered between 2016 and 2025. Indian domestic air traffic may surge fourfold, to 180 million passengers annually by 2020, the government says. IndiGo, which currently operates 32 Airbus jets, plans to start offering overseas service in August.



On the Move

Advanced Micro Devices CEO Dirk Meyer resigns; interim chief is CFO Thomas Seifert • **Newell Rubbermaid CEO Mark Ketchum to retire** • **Barclays Corporate Barclays Capital's Paul Emney appointed CFO**

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Contents ▶ The White House's indecision on tax reform 24 ▶ Bill Daley: Obama's new fixer-in-chief 25 ▶ The trouble with high-risk insurance pools 26 ▶ The Chinese are coming to Washington, with a shopping list 27 ● Edited by Paula Dwyer

A CEO's Dilemma: When Is it Safe to Hire Again?

▶ **Companies won't hire until they're convinced the economy is growing robustly**

▶ **"The economy is adding workers, but there are no reliable signs the pace of hiring is improving"**

President Barack Obama's 2011 charm offensive aimed at American business leaders is ready to roll. The President plans to travel outside the Washington cocoon more often to talk up the recovering economy and exhort U.S. companies, now sitting on a pile of cash, to hire and hire some more. After a contentious 2010, Obama is also extending an olive branch to business leaders with White House staff changes, a Feb. 7 address to the U.S. Chamber of Commerce, and talk of reforming corporate taxes—all in hopes of bringing down the unemployment rate.

None of this matters unless chief executive officers such as Cheryl Merchant are convinced the economy is poised to take off. Merchant runs **Hope Global**, a Cumberland (R.I.) company founded in 1883 as a textile mill that now manufactures niche items like shoestrings for **Timberland** boots, auto parts for Detroit, and weather stripping for home renovators. Situated on the banks of the Blackstone River, closely held Hope Global was slammed by the recession in 2008 and 2009, laying off 25 percent of its 590 employees and shutting operations in Detroit, France, Ireland, and Brazil.

Today, business is rebounding: Revenue in 2010 rose 10 percent, to about $50 million, after falling from about $55 million in 2008. Still, Merchant isn't ready to start hiring again. "I'm not going to bet on the economy," says Merchant, 47, Hope Global's CEO since 1999. "I'm not putting in people believing it's going to happen. It's got to happen first." Meantime, she's "taking care of the people who are here" by restoring a 5 percent pay cut and benefits such as paid holidays.

$9bn
Projected Export-Import Bank financing for small business in 2014, up from $4.5 billion in 2009

Merchant's attitude mirrors those of CEOs across the country. They want to make sure the economy is growing robustly before they commit to new hiring. Yet the economy won't achieve liftoff unless consumer demand picks up, and that won't happen until unemployment falls.

Labor Dept. figures released on Jan. 7 underscore the dilemma. The U.S. added 103,000 jobs in December, and the unemployment rate fell to 9.4 percent from 9.8 percent. While that is the lowest unemployment rate since May 2009, the number of new jobs came in well below the 150,000 that economists forecast in a Bloomberg survey, and the rate declined only because a record number of people abandoned the job hunt, government figures show.

Payrolls need to grow at twice December's rate to drive down joblessness and keep pace with new entrants in the workforce. "The economy is adding workers, but there are no reliable signs the pace of hiring is improving," says Julia Coronado, chief economist for North America at BNP Paribas in New York.

That's why small manufacturers and exporters like Hope Global are crucial to Obama's goal of lowering unemployment, in part by doubling U.S. exports over the next five years. Besides concluding a recent trade accord with South Korea, the Administration on Jan. 13 was set to announce that it would increase financing for small business exporters to $9 billion annually by the end of fiscal 2014 from $4.5 billion in 2009, in partnership with **HSBC**, **Wells Fargo**, **Bank of America**, and **PNC Bank**.

Financing is helpful, but the real issue for Hope Global is a rise in consumer demand for products such as Timberland boots. On a brisk late autumn day, plant manager Joe Silva removes his yellow foam earplugs and shouts over the drone of 800 braiding machines to explain how it makes shoestrings for the Chinese makers of the high-end boots. Silva says the braiders, spinning at 300 revolutions per minute, heat the shoelace tips so they don't fray—as opposed to attaching plastic ends that are less durable. Timberland demands that the strings be sturdy and waterproof. They also must come in hundreds of color combinations. Timberland uses Hope's laces in China and for a factory in the Dominican Republic because "their quality, cost, and delivery meet our standards, and having one trusted source ensures consistency," says Tom Conneen, director of nonleather materials for Stratham (N.H.)-based Timberland.

One ray of hope for Hope Global may be the auto industry. More than two-thirds of its revenue comes from the sale of auto parts such as components for the insides of car seats and the netting for cargo holds of sport-utility vehicles. Auto sales are climbing again but remain well below pre-recession levels (page 40).

Merchant draws from years of experience on assembly-line floors at **General Motors**, **Mazda**, **Ford Motor**, and parts maker **Lear**. A native of Ithaca, Mich., she got a job as a supervisor in the paint shop for the Cadillac Fleetwood Brougham after graduating from Alma College in Alma, Mich. She was often the only woman on her shift. She ran a Ford seat-making plant in Mexico and moved to Lear when

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PHOTOGRAPHS BY BOB O'CONNOR FOR BLOOMBERG BUSINESSWEEK; BOOTS: TIMBERLAND

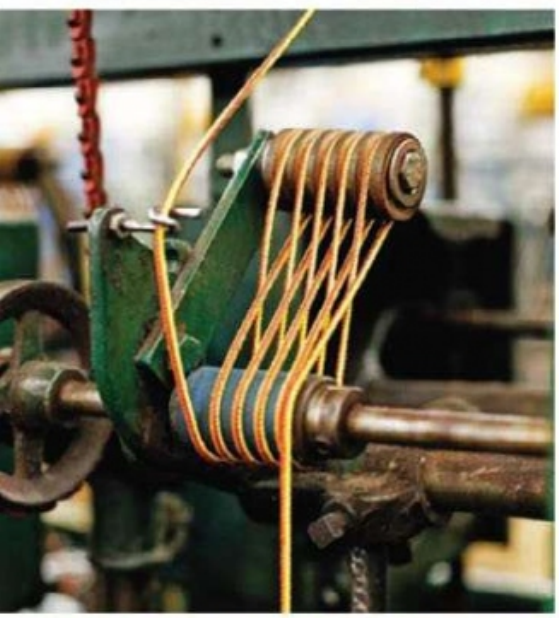
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In Rhode Island, Hope Global produces laces in hundreds of color combinations for the Chinese makers of Timberland boots. Machines heat the tips so they don't fray















"I'm not going to bet on the economy. I'm not putting in people believing it's going to happen. It's got to happen first."
—Cheryl Merchant, Hope Global CEO

Tax Reform: What's on The Table

Rewriting the Tax Code would require painful choices about which individual and corporate tax breaks to end.






Exclusion from taxation of employer-paid health insurance premiums and medical care	Exclusion from taxation of contributions to 401(k)s and similar retirement savings plans	Mortgage interest deduction	State and local tax deductions
ONE-YEAR COST 131bn	ONE-YEAR COST 118bn	ONE-YEAR COST 88bn	ONE-YEAR COST 78bn
Beneficiaries Individuals, Health insurers, Employers	**Beneficiaries** Individuals, Financial institutions, Businesses	**Beneficiaries** Individuals, Lenders, Housing industry	**Beneficiaries** Taxpayers who itemize deductions

the parts manufacturer bought the operation in 1993. After supervising Lear factories in Canada and Eastern Europe, Merchant was recruited by David Casty, Hope's owner. Casty died in 2003, and his son Ronald now leads Hope's board of directors.

Hope's advantage is its ability to shift production to low-cost countries when price is a big issue. It does that now with the SUV cargo nets. Workers at the Rhode Island plant, who earn more than $11 per hour, produce the basic material, then send that to a plant in Leon, Mexico, where workers making about $3 an hour hand-weave the finishing touches. The nets are then sold to auto parts suppliers.

If Merchant hires this year, it will be largely at Hope Global's plants abroad. She added 20 workers in Mexico in December. If the economy picks up, she hopes to open a plant in Shanghai to make knitted steel that's used to reinforce the rubber seals of car doors and trunks. "People ask me how I maintain an American company," she says. "We're not doing it with a wall around ourselves. We're doing it by being global."

And for now, that means hiring new U.S. workers isn't a sure thing. "We're very solid. The banks love us," Merchant says. "You start adding a bunch of headcount without the sales, and all you're doing is taking from your bottom line." —*Ian Katz with Bob Willis*

The bottom line *For the U.S. to reduce unemployment, companies like Hope Global need to be sure the economic recovery is real.*

Taxes

Reform Is in the Eye of the Beholder

▸ Obama wants any overhaul to trim the deficit or be revenue neutral

▸ "I don't want to see tax reform that ends up raising people's taxes"

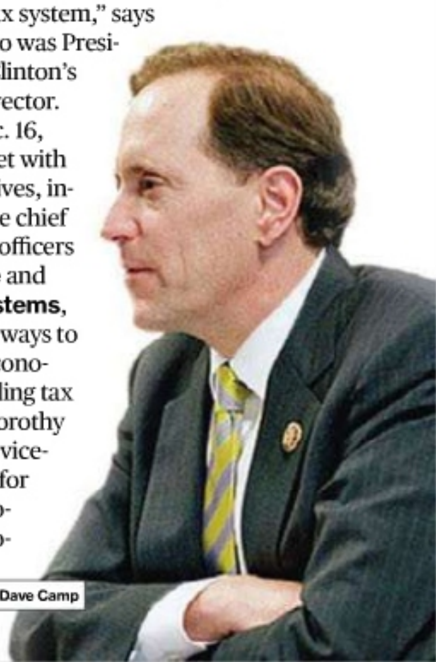
In an increasingly polarized Congress, most lawmakers agree that the U.S. Tax Code is unfair, complicated, and inefficient. Yet as President Barack Obama and his economic team consider making tax reform a centerpiece of the State of the Union address this month, they keep bumping up against a simple question: Is it worth it?

The White House is mulling a plan to revamp the code, starting with corporate taxes, Treasury Secretary Timothy Geithner said on Jan. 12. "We're examining whether we can find the political support for a comprehensive tax reform," Geithner said. The Obama team's one condition is that any overhaul must either raise revenue to cut the $1.3 trillion budget deficit or be "revenue neutral," meaning some corporate taxes may rise or fall as long as the levy produces the same amount it does now.

Congressional Republicans say they are eager to work with Obama, and most agree with Democrats that lowering tax rates would involve painful choices to offset lost revenue, including curbs on cherished tax breaks such as the deduction for interest on home mortgages or subsidies for corporations' overseas investments. Within the White House, a vigorous debate is under way over whether picking those fights would be worth the political pain if the deficit isn't also slashed, says a top Administration official who insisted on anonymity to discuss an internal debate.

Republicans say reforms must lower taxes for all—and include both individuals and companies. "Our problem is not a lack of revenue, so I don't want to see tax reform that ends up raising people's taxes," says Senator Jon Kyl (R-Ariz.), the minority whip. Alice M. Rivlin, who served on the deficit reduction commission that in December urged a wholesale rewrite of the code, disagrees. "We need to find a way of raising more revenue, but with a more efficient and more growth-friendly tax system," says Rivlin, who was President Bill Clinton's budget director.

On Dec. 16, Obama met with 20 executives, including the chief executive officers of **Google** and **Cisco Systems**, to discuss ways to fuel the economy, including tax reform. Dorothy Coleman, vice-president for tax and domestic eco-


Representative Dave Camp



Accelerated depreciation of machinery and equipment

ONE-YEAR COST
56bn

Beneficiaries
Manufacturers
Agribusiness



Charitable contribution deduction

ONE-YEAR COST
47bn

Beneficiaries
Individuals
Charities
Universities



Deferral of income from foreign operations

ONE-YEAR COST
32bn

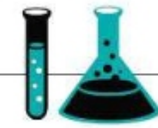
Beneficiaries
Multinational companies



Lower tax rates on investment income

ONE-YEAR COST
24bn

Beneficiaries
Wealthy individuals



Credit for research and development expenses

ONE-YEAR COST
6bn

Beneficiaries
Pharmaceutical and other research-intense companies

DATA: TAX POLICY CENTER, JOINT COMMITTEE ON TAXATION. ALL FIGURES 2008 EXCEPT R&D TAX CREDIT IS A 2011 ESTIMATE.

nomic policy at the National Association of Manufacturers (NAM), says her group has recently spoken with Administration officials about a broad overhaul. Geithner was scheduled to meet with chief financial officers on Jan. 14 to continue the discussion, a Treasury spokeswoman said.

One question is whether corporate and individual tax rewrites can be accomplished in tandem. Representative Dave Camp (R-Mich.), the new chairman of the tax-writing House Ways and Means Committee, says he wants to tackle both together. The Administration says only the corporate code is up for discussion now. Coleman says that approach would not satisfy NAM, many of whose companies are structured as S corporations, in which owners pay taxes on company profits at the individual rate rather than the corporate rate.

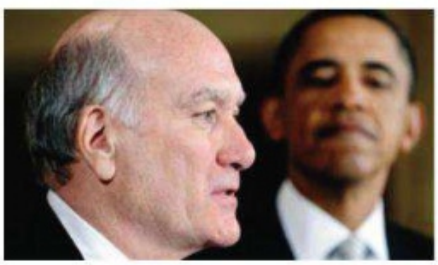
Administration officials agree sweeping reform is a long shot. The most apt comparison may be the 1985-86 overhaul that dramatically lowered individual rates while subjecting more income to taxation by curbing special breaks. In 1985 there was a Republican President and Senate and a Democratic-controlled House. A coalition of Democratic tax reformers and supply-side conservatives who wanted lower rates joined together to take on the special interests. Still, it took a politically painful year and a half before a measure was enacted. There is little sign of such an alliance today. *—Albert R. Hunt, Ryan J. Donmoyer, and Rich Miller*

The bottom line *Administration officials are debating whether to reform the Tax Code. If they start with corporate taxes only, they'll face GOP resistance.*

ILLUSTRATIONS BY MATT OWENS; DALEY: JEWEL SAMAD/AFP/GETTY IMAGES

The Administration

Fixing Things The Chicago Way



▶ **Bill Daley brings pragmatism and charm, no knife, to White House fights**

▶ **"Rahm had the trust of Congress. Bill has the trust of business"**

William M. Daley has been a lawyer, banker, and rainmaker. He's managed companies and political campaigns, and served as a Cabinet official. But above all, Bill Daley has been a fixer for powerful bosses in and out of government.

His ultimate challenge may be the job he accepted on Jan. 6 as chief of staff to a President facing a strengthened opposition, a sluggish economy, and reelection in 2012. "Every chief of staff kind of fits the moment," says Rahm Emanuel, who sought Daley's advice almost weekly when he was in the job. Emanuel recommended Daley when he told Obama he was mulling a run for Chicago mayor after Daley's brother Richard decided against a seventh term. "Bill will fit the moment, going into this reelect," says Emanuel.

With Daley on board, Obama's next two years are likely to be markedly different from the first two. It will be "a time of negotiation and compromise, checks and balances, and trying to find common ground rather than creating a landslide of legislation all on one side of the aisle," says former Reagan Chief of Staff Kenneth M. Duberstein, a Daley friend and fellow Boeing board member who met with Obama in December.

Daley, 62, a centrist Democrat known for his negotiating skills, gives Obama added credibility as someone who can cut budget and trade deals, issues Obama now wants to emphasize. He also gives Obama something Emanuel didn't: "Rahm had the trust of Congress," says Leo Melamed, chairman emeritus of CME Group, parent of the Chicago Mercantile Exchange and the Chicago Board of Trade. "Bill has the trust of business."

Daley's first White House assignment was persuading Congress to pass the North American Free Trade Agreement in 1993, a task not unlike the one he faces now—charming both an ascendant opposition and the sometimes hostile members of his own party. Daley also had to get a Democratic House to ignore labor's objections while overcoming business doubts that President Bill Clinton was serious. "Daley helped to bridge that gap," says Christopher Padilla, an IBM government relations vice-president. "He knows how to talk to business." In the end, Nafta passed with 102 House Democrats joining 132 Republicans.

After his 1996 reelection, Clinton made Daley his Commerce Sec-

retary, a job Daley held until the summer of 2000, when Al Gore asked him to manage his troubled Presidential campaign. Gore was down 25 points in the polls; Daley helped him catch up, though he didn't prevail. On election night, after Gore had conceded, it was Daley who bounded down the steps of the Tennessee War Memorial building to tell supporters that Gore would fight on. Gore later said he might have won the election had Daley joined the campaign earlier.

In 2003, when Daley was president of **SBC Communications**, the power of the family name was on full display. SBC won passage from the Illinois legislature of a measure—just four days after its introduction—that gave SBC broad latitude to raise the fees it charged competitors for using its network. Obama, then a state senator, was one of those who voted no. "Ramrodding bills through because you've got the clout to do so—rather than because you've got arguments on your side—is not a good way to do the people's business," Obama told the *Chicago Tribune*. A court later overturned the measure.

Daley took on a quieter lobbying role when he joined JPMorgan Chase in 2004 as Midwest chairman. He never really worked as a banker in the traditional sense. "It's less investment banker than it is political coordinator," says Melamed of CME. When the Chicago Merc was trying to acquire the Chicago Board of Trade four years ago, Daley's role at JPMorgan, an adviser on the deal, was to make sure antitrust issues didn't trip it up, says a person who worked on the $11.3 billion transaction. Daley was rarely seen during the talks, but whenever regulators raised concerns that might slow the deal, Daley made sure they were addressed, says this person, who asked to remain anonymous because the talks were private.

Daley played a similar role as Congress considered the financial rules overhaul. He didn't register as a lobbyist, though he hired and supervised Peter L. Scher, who worked alongside Daley in the Clinton Administration, to lead JPMorgan's lobbying units. Daley revamped the bank's strategy by bringing in Chief Executive Officer Jamie Dimon and other managers to meet personally with lawmakers. In the end, JPMorgan and other big banks won key concessions on derivatives and how much of their own capital they could invest in hedge funds and private equity deals.

After Obama introduced him at the White House, Daley reminisced about a visit he made there 50 years ago this month, just after John F. Kennedy had been sworn in. As John Daley, another brother, recalled, "Kennedy specifically said that he would not be there without my dad," a reference to Richard J. Daley who, as then-Chicago mayor, helped Kennedy pull off a narrow and controversial win in Illinois in 1960. Fixing things is an old Daley family tradition. —*John McCormick, with Julianna Goldman, Robert Schmidt, Mark Drajem, Jeffrey McCracken, and Flynn McRoberts*

The bottom line *Bill Daley, Obama's new chief of staff, will try to improve relations with business and Republicans, with an eye toward the 2012 election.*

Health Care

A Shaky Debut for High-Risk Insurance Pools



▶ **Poor marketing and high costs hurt the government plan's enrollments**

▶ **"This is a striking statement" about health reform, says one GOP critic**

Government-funded health plans for high-risk patients, an early feature of the new health-care law, have attracted just 2 percent of expected users. The disappointing start has given Republicans, once champions of the plans, ammunition in their push to repeal President Barack Obama's entire health-care overhaul passed last March.

Much of the law phases in over time: A ban on private insurers denying adults with preexisting medical conditions doesn't start until 2014. To fill the gap for those consumers, $5 billion was set aside to fund high-risk insurance pools that were put into effect in July, offering one of the first tests of the overhaul's usefulness. One problem: Although

The Daley Chronicle

Bill Daley has worked as a "fixer" for high-profile bosses in business, politics, and the federal government:



August 1993

Having helped deliver Illinois to candidate Bill Clinton in the 1992 election, he is tapped by the President to overcome House Democratic and union resistance to the North American Free Trade Agreement. Nafta passes in November 1993 (above) by a 34-vote margin with the support of 102 Democrats and 132 Republicans.



1997-2000

He becomes Secretary of Commerce in the second Clinton Administration and helps push legislation that clears the way for China's entry into the World Trade Organization.



June 2000

Trailing by 25 points in the polls, Al Gore hires Daley to chair his faltering Presidential campaign. Daley also helps manage the Florida recount for Gore, who later says he might have won the election had Daley joined the campaign earlier.



2001-2004

Telecommunications company SBC hires Daley as president, mostly to help lobby for favorable regulation. A month after the Illinois legislature adopts a 2003 bill favorable to SBC, a federal judge rules the measure anticompetitive and contrary to federal law.



2004-2010

Joining JPMorgan Chase, Daley oversees lobbying and the bank's Midwest division. Under him, JPMorgan opposes a standalone consumer financial protection agency and stringent derivatives rules.

DATA: BLOOMBERG

BLOOMBERG; AFP/GETTY IMAGES; AP PHOTO (2); POLARIS; REDUX; REUTERS

Want a Verizon iPhone? Read this first page 31 ▶

the new health-care law requires premiums for the high-risk plans to track those charged by private insurance plans for customers in good health, those rates have still proven unaffordable for many, according to Jean Hall, an associate research professor at the University of Kansas in Lawrence who has studied the program. Pennsylvania's program, which has the top enrollment among states (1,657 as of Oct. 1), charges $283 per month for coverage, one of the lowest premiums in the nation. The Medicare program's chief actuary predicted in April that 375,000 people would enroll nationwide by the end of 2010. Only 8,011 had signed up as of Nov. 1, government figures show.

Republicans say the disappointing enrollment is a reason to repeal reform. "If the main goal of passing a trillion-dollar bill was to help people with pre-existing conditions, this is a striking statement about the law," says Laena Fallon, a spokeswoman for Eric Cantor (R-Va.), the House majority leader.

High-risk pools were key features of health-care plans introduced in 2008 by Presidential hopeful Senator John McCain (R-Ariz.) and by current House Speaker John Boehner (R-Ohio) last year. Republican versions would be better funded than Obama's and would allow the states to build on existing programs, decreasing administrative costs, says Fallon.

The Administration hasn't had enough time to publicize the plan or experiment to see which benefit packages would be most affordable, says Richard Popper, a director of insurance plans with the U.S. Office of Consumer Information and Insurance Oversight. Still, for those enrolled, the program is "making a difference in people's lives, saving people's lives," he says.

The federal government plans to increase its marketing of the plans for 2011, and private insurers like **Humana**, **UnitedHealth Group**, and **WellPoint** have agreed to tell people they denied coverage to, Popper says. Premiums this year will also be trimmed by 20 percent for the U.S.-run program's basic plan. The program will also add two more benefit options and offer a lower deductible for drug coverage, he says. —*Alex Nussbaum*

The bottom line *Low enrollment in government-funded insurance programs aimed at sick patients has emboldened GOP critics of health-care reform.*

Foreign Policy

China Wants to Rebalance Its Portfolio

▶ Hu Jintao is coming, and he plans to do some deals

▶ "You have to be careful that you temper the graciousness"

President Barack Obama is having America's banker over for dinner. Two nights in a row.

Hu Jintao, the Chinese President, arrives in Washington on Jan. 18 for a state visit aimed in part at diversifying an investment portfolio that includes $906.8 billion in U.S. Treasuries, the largest foreign holdings of U.S. debt. That could mean a flurry of commercial deals, or so the White House hopes. Accompanying Hu will be Chen Deming, the Commerce Minister, and Lou Jiwei, chairman of the country's sovereign wealth fund. The Chinese government has indicated it may be shopping for some clean-energy cooperative ventures. "I'm sure when the visit wraps up we're going to see many outcomes, including in the economic and trade field," Cui Tiankai, China's vice-foreign minister, said on Jan. 12 in Beijing.

That's welcome news for the White House, which has made doubling U.S. exports key to its job creation plans, an Administration official says. Obama will treat Hu to a private supper when he arrives and to a formal state dinner the next night. (The state dinner is an honor Hu did not get during a 2006 visit.) Secretary of State Hillary Clinton will also host a lunch. "They are rolling out the red carpet," says Representative J. Randy Forbes (R-Va.), a co-founder of the Congressional China Caucus who sees Beijing's growing economic and military power as a potential threat. "You have to be careful that you temper the graciousness with also hardness and strength," he adds.

$906.8 BILLION

The amount of U.S. Treasuries held by China

While Obama plans to raise some of the thornier issues that have bedeviled relations, including Iran, North Korea, and human rights, most of the discussions will focus on commercial cooperation. The White House hopes to replicate the success of Obama's November trip to India, where he secured $10 billion in commercial deals, says the Administration official, who requested anonymity to discuss White House planning. Obama and Hu will attend a forum of about a dozen Chinese and American chief executive officers, including Jeffrey Immelt of **General Electric**, Jim McNerney of **Boeing**, and Gregory Brown of **Motorola Solutions**. High on China's agenda is its need to tap new sources of energy to power its growing economy. Lou, the chairman of **China Investment Corp.**, is scheduled to speak at a Washington conference on U.S.-China cooperation on clean energy. The heads of **China National Nuclear** and **State Grid Corp.** also will address the conference.

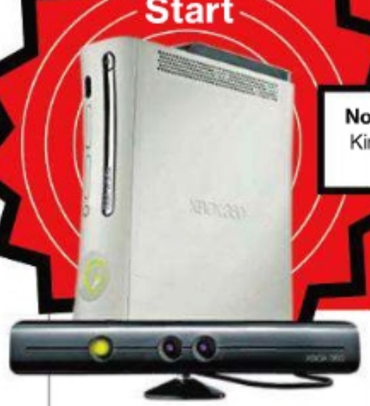
From Washington, the delegation will travel to Chicago, where Hu is expected to visit a suburban Chinese-owned auto parts company, **Wanxiang America**. Chicago is also home to Boeing's headquarters. In 1997, during the last full-dress state visit by a Chinese leader, Presidents Bill Clinton and Jiang Zemin announced a $3 billion Chinese order for Boeing jets. —*Hans Nichols and Michael Forsythe*

The bottom line *Chinese President Hu Jintao's upcoming U.S. visit will include some diplomatic talk and, U.S. officials hope, commercial deals aplenty.*



Contents ▶ A weird and wonderful Consumer Electronics Show 30 ▶ The Verizon iPhone: Read this before you buy one 31 ▶ Verizon CEO Seidenberg talks about the iPhone—and AT&T—with Charlie Rose 32 ▶ Innovator: Stephen Quake's speedy gene-testing chip ● Edited by James Aley

Start



The Kinect

Nov. 4, Midnight
Kinect released in the U.S.

11/4

Nov. 4, Morning
DIY-kit seller Adafruit offers $1,000 to the first person to break open Kinect's software code

Nov. 4, 4:03 p.m.
"Microsoft does not condone the modification of its products," a company spokesperson tells CNET

11/16

Nov. 16
Microsoft says it has sold 1 million Kinects

11/22

Nov. 22
Willow Garage inserts Kinect code into its robot operating system

12/1

Dec. 1
Microsoft says Kinect sales reach 2.4 million

predicts 5.5m for year

12/9

Dec. 9
PrimeSense, creator Kinect's hardware, acknowledges the creative ferment and opens a version to developers

01/5 2011



Jan. 5, 2011
Steve Ballmer announces Kinect sales of 8 million

How to Kinect With Hackers

▶ Microsoft risks alienating coders who love its hit gaming device

▶ They "really missed the boat"

Bearded, clad in a hoodie, and with a mouthful of swear words, hacker Kyle Machulis took the stage last month at San Francisco music joint Rickshaw Stop. He was there to deliver a Nerd Night talk about his latest love: **Microsoft**'s Kinect, a gesture-and-voice-recognition accessory for the Xbox gaming console that lets people play video games without having to hold a controller. "This thing costs $150 and is sold at **GameStop**," Machulis told the crowd. "Oh, s--t! We live in the future!"

Machulis serves as one of the leaders of the Open Kinect project, an ad hoc effort backed by thousands of hackers and DIY. enthusiasts. They've cracked open and studied Microsoft's latest device and are now putting it to unexpected new uses, ranging from commanding robots with hand motions to performing sex acts on avatars.

The intense interest that Kinect has drummed up in geekdom presents Microsoft with an unfamiliar opportunity. At a time when **Apple**, **Google**, and other tech giants are vying to reach independent developers who make the ingenious software apps that have reshaped the market for things like smartphones and tablets, Microsoft has stumbled onto a direct path to them. Experts say that if Microsoft can focus the energy of that horde, the company may be able to leverage Kinect's early success and dominate the next era of human-computer interactions, in which PCs, phones, and other electronics can be controlled by body movements and voice commands instead of keyboards and mice. "Microsoft has succeeded despite themselves in creating something

$3,000 Prize

Nov. 4, Evening Adafruit raises ante

11/5

Nov. 5 Microsoft releases less-terse statement. Says it will not sue developers

11/7

Nov. 7 Code Laboratories in Nevada claims it's hacked Kinect; says it can be yours for a $10,000 "donation"

11/10

Nov. 10 Kinect goes on sale in Europe and is hacked that day by a Spaniard who claims the Adafruit prize

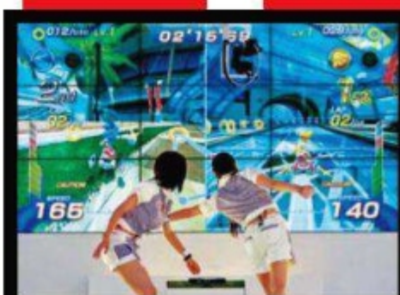
really cool," says Matt Asay, a prominent open-source blogger and executive at software startup Strobe. Yet a number of critics say the relationship between Microsoft and Kinect-loving geeks is already strained, and that Microsoft's early reactions to their playful tinkering suggest it could squander a once-in-a-generation opportunity. "Here was a chance to throw themselves deep into the bowels of the open-source hippy movement," Asay says. "They are kind of trying to do it, but they don't want to touch anyone in the mosh pit."

Kinect has provided Microsoft with a long-awaited consumer-electronics hit. Chief Executive Officer Steve Ballmer, speaking at the Consumer Electronics Show earlier this month, revealed that Microsoft has sold 8 million of the devices since their launch in November. Kinect has extended interest in the Xbox beyond gamers to entire families and has helped Microsoft add 5 million subscribers to Xbox Live, its online home entertainment service, since November. That's a 20 percent increase. Hundreds of millions in marketing dollars helped make Kinect the unquestioned champion of the holiday season.

The Open Kinect project was also an immediate success—albeit one without Microsoft's blessing. When Kinect appeared on store shelves, **Adafruit Industries**, an online seller of DIY electronics kits, offered $1,000, then $3,000, to the first person who could analyze Kinect's innards and share the information with developers at large. It took all of six days before the Kinect's secrets were cracked. "That's when things exploded," says Machulis.

Geeks around the world set to work. One strapped a Kinect to a Roomba, letting him steer the robot vacuum cleaner by waving his hand. Others used Kinect to control World Of Warcraft characters with their bodies rather than keyboards. A pair of developers projected virtual puppets onto a wall and manipulated them with hand gestures. And inevitably, there's the porn: **thriXXX**, a maker of 3D interactive sex games, announced a PC game that will let players massage, whip, and otherwise interact with virtual paramours.

Microsoft responded to Open Kinect as one might expect of a company long suspicious of hacking. In statements, Microsoft said it "does not condone the modification of its products" and vowed to work with law enforcement "to keep Kinect tamper-resistant." After geek outrage spilled onto the Web, Microsoft spent the next day clarifying its position. It stressed that it objected to miscreants who might, say, use Kinect's camera to peer into living



The device is a hit with regular gamers

11/11

Kinect mania begins on YouTube. Flood of amazing demonstration videos

11/14

Nov. 14 Kinect works on Mac; virtual air-painting app is born

11/15



The robot vacuum gains the power of sight

Nov. 15 Software code for Kinect, hosted on GitHub.com is viewed 15,051 times

CLOCKWISE FROM RIGHT: YURIKO NAKAO /REUTERS; COURTESY PHILIPP ROBBEL; ANDREW HARRER/BLOOMBERG



Sell on the rumor? Definitely page 36 ▶

rooms. It would not, however, sue well-intentioned tinkerers. After that peace gesture, Microsoft stopped discussing Open Kinect publicly. (The company declined to comment for this story beyond reiterating enthusiasm for Kinect.)

Sam Ramji, a former Microsoft executive who led its open-source strategy, credits the company for saying it wouldn't sue the hackers. Still, Ramji says Microsoft should go further and actively support them, just as Apple found a way to channel developers' interest in the iPhone into the highly successful App Store. "Companies should make it easy for people to hack," says Karim Lakhani, an assistant professor at Harvard Business School who studies open-source projects. "Why wouldn't you want people going crazy with your products?"

Dan Barry, a former astronaut who is using a hacked Kinect to solve thorny robotics challenges–such as getting a bot to tell the difference between a picture of a person and an actual person–says Microsoft "really missed the boat" by distancing itself from Kinect enthusiasts. "They brought out this amazing sensor and just focused on the Xbox." The Kinect has won over robotics experts in particular, he says, because it's crammed with technology that would otherwise be difficult to replicate or expensive to buy. With its cameras and depth-perception software, the Kinect is a viable replacement for the $5,000 laser range finders typically used to guide robots, Barry says.

Microsoft shows no sign of exploiting that edge, which is ironic given that the company has also invested heavily in robotics software. And it has allowed other companies to elbow in. **Willow Garage**, a robotics startup in Silicon Valley, is offering $8,000 in prizes for Kinect apps. **PrimeSense**, the Israeli company that makes Kinect hardware, has rushed out a developer version of its product.

If Microsoft remains ambivalent, it risks losing its position at the eye of this storm of innovation. "Right now everyone is positioning themselves to get a piece of the action," Machulis says. Microsoft has "not really been jumping out and helping us. They just haven't been doing anything to stop us."

—*Ashlee Vance*

The bottom line *Microsoft's Kinect, a consumer hit, presents a rare chance for the company to harness the enthusiasm of hackers.*

Consumer Electronics Show

What Happens in Vegas Is Actually Pretty Cool

▶ A dispatch from the most innovation-filled CES in years

▶ If a device "doesn't connect to the Internet, it seems almost deficient"

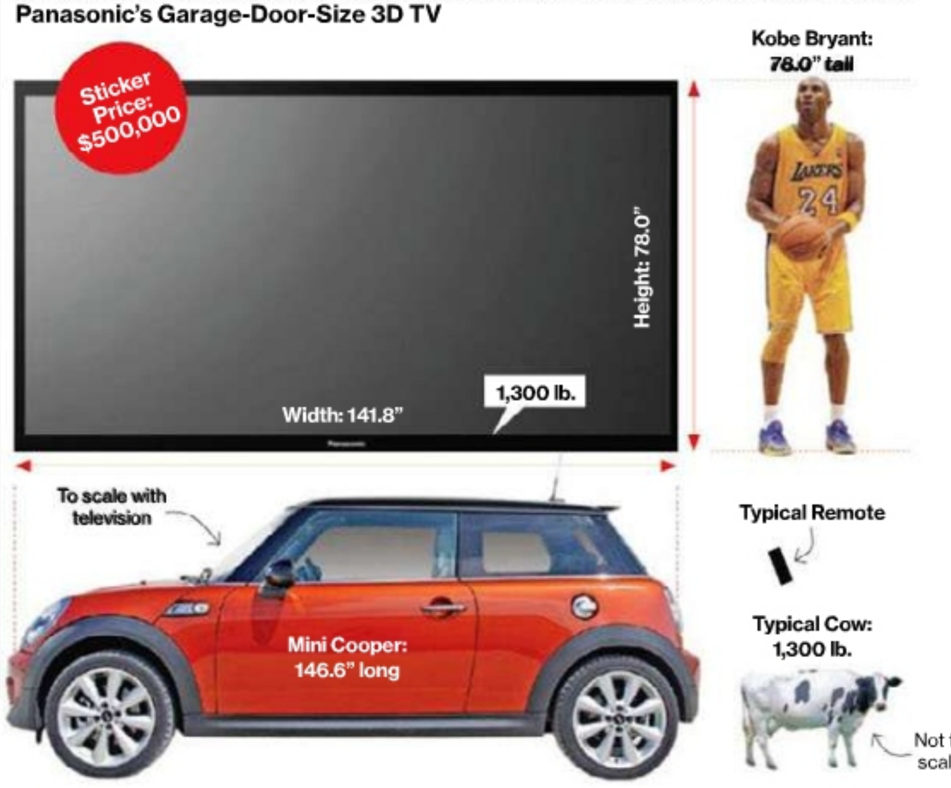


By the end of last week's International Consumer Electronics Show in Las Vegas, attendees seemed to share a collective lethargy. Was there really anything new?, they asked each other on the crowded and claustrophobic exhibition floor. In an onstage interview hosted by the technology blog AllThingsD, **Twitter** Chief Executive Officer Dick Costolo exemplified the jadedness, calling CES a "quantum conference"–with progress that occurs on a subatomic scale. "This seems like an incremental year," he said.

Perhaps high tech's most celebrated annual gathering, which concluded on Jan. 9, simply wears its participants down. More than 140,000 people crammed in, up 17 percent from last year. At times it seemed like most of those attendees were waiting in the same cab line–or trying to make a phone call on the same overtaxed cellular network. But for someone who had stepped into a time machine a few years ago and emerged in Las Vegas earlier this month, the conference would have felt momentous, perhaps magical. The technology on display at CES was more diverse, more interconnected, and in some cases just plain more weird than ever.

The most dramatic evidence of innovation could be found, as in past years, with trophy TVs–those cutting-edge displays meant not to appeal to regular folks but to win bragging rights. There were impossibly large screens (**Panasonic**'s 152-inch plasma, which sells for about $500,000, cost of new house

Panasonic's Garage-Door-Size 3D TV





CES attendees view LG's 84-inch Ultra Definition 3D TV

not included) and incredibly thin ones (**LG Electronics**' 2.9-millimeter-thick OLED TV, which is not yet on sale and was enshrined in protective plastic). **Toshiba** and **Sony** showed prototypes of 3D televisions that dispense with the dorky glasses but oblige viewers to sit directly in front of the screen. It's an early glimpse of a technology that the companies say is still several years away, though one wonders whether it will undermine the present prospects for 3D TV as people wait for a goggle-free future.

While tablets of almost every size and shape dominated the media coverage, consumer-electronics makers also showed off the next generation of handsets, which will be smarter, faster, and more versatile than those in our pockets now. **Motorola Mobility**'s Atrix 4G phone, for example, has an **Nvidia** dual-core microchip—that's more processing power than the laptop you owned four years ago—and can obviate the need to carry a separate computer by plugging it into a lightweight laptop with no processor of its own. Manufacturers of just about everything promised that their new devices will connect to each other and to the Web. "It's inescapable now," says Charles S. Golvin, an analyst at Forrester Research. "If the device in your hand or in front of you doesn't connect to the Internet, it seems almost deficient."

One recurring theme at this year's CES was that the familiar keyboard, telephone dial pad, and video game controller might soon become artifacts of our computing past. At the sprawling **Microsoft** booth at the center of the show, attendees stood in long lines to get their chance to wave madly at a video game screen. Many were seeking out their first experience with Kinect, the company's add-on for the Xbox gaming console that lets people play games and control the device and services like **Netflix** with hand gestures and voice commands. Along the same lines, **TCL**, a Chinese consumer-electronics manufacturer, demonstrated a television with motion sensors that lets viewers change channels with a flick of the wrist. The system is still in development. **Dijit**, a five-person startup based in San Francisco, demonstrated a mobile application that will allow people to use their smartphones as TV remote controls, browsing through program guides that incorporate on-demand video from sites like Netflix and recommendations from friends on social networks. "Just figuring out what you want to watch these days is becoming a beast," says Maksim Ioffe, Dijit's Lithuanian-born founder.

Attendees could find even wackier products if they knew where to look. In the Robotics TechZone, the Wheeme robot massager, from the hedonistic inventors at an Israeli company called **DreamBots**, wheeled over the torsos of attendees, gripping and lightly caressing their sore back muscles. It's the size of a radio-controlled toy car and costs around $69. Elsewhere, a pair of graduates from the famed MIT Media Lab said they wanted to restore the magic of tactile play to video games. Later this year, their startup, **Sifteo**, will start selling packages of white cubes with 1.5-inch touchscreens. The cubes connect to each other and to a PC, and can be loaded up with a variety of games that require players to move and manipulate them like a set of high-tech dominoes. "We are inventing the future of games by incorporating from their past," says Sifteo's co-founder, David Merrill.

Adding to the aura of randomness, Lady Gaga swept onto the show floor to demonstrate **Polaroid** sunglasses that take photos and video and have built-in screens. The rappers 50 Cent and Ludacris each unveiled a line of wireless headphones. And an actor in Darth Vader garb appeared in the booth of **20th Century Fox** to help announce the Blu-ray release of the *Star Wars* films. Those movies are science fiction, but as this year's CES demonstrated, the present now has its own shades of sci-fi. Drained attendees may dismiss that notion; maybe it's just happening too slowly for them to notice. —*Brad Stone*

***The bottom line** The technology at this year's CES, high tech's premier event, was more diverse, more connected, and sometimes more weird than ever.*

Mobile Networks

Panting For a Verizon iPhone? Read This First

▶ Weighing the pros and cons of Verizon vs. AT&T

▶ "Verizon planned its network with greater foresight than anyone else"

For more than three years, iPhone owners have grumbled about dropped calls and slow service on **AT&T**, the exclusive cellular network for **Apple**'s transformative device. Now they'll have the chance to see if **Verizon** can do any better. The company recently announced it will start selling iPhones on Feb. 10. (Existing customers can preorder the phone on Feb. 3.) For those who still haven't chosen sides in the AT&T vs. Verizon showdown, consider these points before signing a contract:

Price: Verizon customers will pay the same as AT&T's—at least for the device itself. A 16-gigabyte iPhone costs $200, while the 32-gigabyte model is $100 more. The more important retail factor, however, is the monthly service charge, and Verizon hasn't released any details yet. The industry scuttlebutt is that the company will offer an all-you-can-eat data plan, which AT&T stopped doing last year to keep data hogs from straining its network.

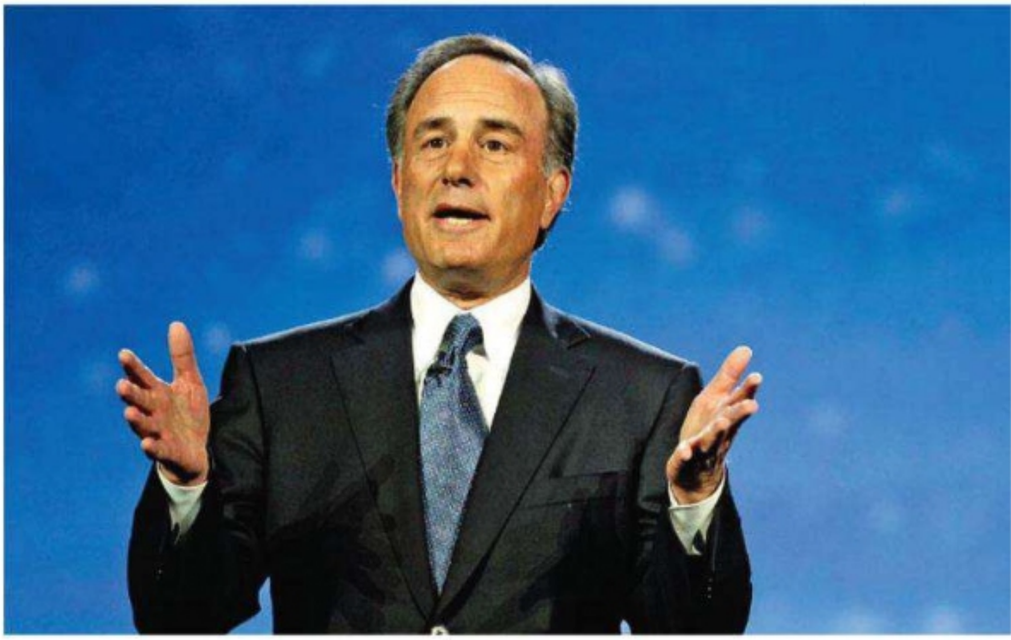
➔ 33

CLOCKWISE FROM TOP LEFT: CJ BURTON/CORBIS; THE ORANGE COUNTY REGISTER/ZUMA PRESS; NOAH GRAHAM/NBA/GETTY IMAGES; NIGEL CATTLIN/ALAMY;
DATA: PANASONIC; MINI USA; NBA; UNIVERSITY OF NEBRASKA-LINCOLN

Charlie Rose talks to Ivan Seidenberg

"We can have a lot of fun … banging heads with AT&T"

On the day of the Verizon iPhone announcement, CEO Seidenberg discusses a complex courtship with Apple—and boasts about the strength of his wireless network



Do you expect to have the problems AT&T had with the iPhone? The argument is that its network was overwhelmed.
We've prepared greatly. We've observed everything that's gone on with what they've done. A little-known fact is that we carry almost as much data as they do. So even though we don't have the iPhone today, our Droid users are heavy data users. … So we've had good success in carrying a lot of data up until this point. We think a key issue for us is going to be that customers, if they get a better experience on a smart device using our network, that's going to be a very important element of our marketing strategy. We think we're ready, and we're not going to talk much about it. We're just going to let the performance speak for itself.

How did this Apple tieup come into being? What changed?
I don't think anything changed. It all started with Apple, and Apple decided that it wanted one carrier in every major market. So Apple and AT&T consummated a deal three years ago. And because Apple was more focused on a single technology—the GSM technology—they chose AT&T. We had good discussions with them, but it was clear to us that they weren't looking to make a device for both sets of technologies.

Did you think they made unreasonable demands at the time?
No. That was all part of the sort of mating dance they were going through. But most of that [was] used not against us, but used against the carriers they ended up signing with, all right? So no, I didn't think the terms were all that serious because we were never in the running. Now, over the course of the last three years, particularly if you go to Europe and some of the Asian countries, Apple expanded to a second carrier. And it was time for them to expand to a second carrier here. So yeah, we did have a lot of discussions with them over the last couple years. We even installed antennas on their campus, and they tried our technology. When they were ready to make a decision to add a second carrier, we made sure that they had a favorable impression.

But did Ivan initiate this by calling up Steve and saying, "Let's take another look at this"?
Yeah. Well, I did. I did call up Steve and go visit him. Lowell McAdam [Verizon Wireless president and COO] called up [Apple COO] Tim Cook and went to visit him. So it was not just a one-person thing. We consciously reached out to them more than once. This was the view that we had that … eventually their interests would align with ours.

What does this day say about you, and what does it say about Steve Jobs? That you never give up?
In terms of Steve Jobs, I think this is just another arrow in his quiver. He's done a great job at innovating, and he's got a product that people feel like they want to carry. And we did want to carry the iPhone. I would also make this point: We're further along in 4G than others are. So I think this decision, from Apple's standpoint, is also very strategic because they get to establish a relationship with us early in their cycles to take advantage of the 4G stuff that's going to come out over the next 12 months. If you do your job well, then in an industry like this, eventually the right partners are going to end up on the dance floor.

So now there is going to be a CDMA version of the iPhone. Where's the industry headed?
In the U.S., when the wireless indus-

Technology



"In terms of Steve Jobs, I think this is just another arrow in his quiver"



try was formed ... everybody chose a slightly different technology because they thought it was going to work better. We chose CDMA, even though it wasn't the dominant technology–GSM was. We thought we could do more with the spectrum ... than we could with GSM. And we did. For 15 years we did fine. We have a better network ... higher customer satisfaction. But when you get to 4G, we were all able to get onto a common standard called LTE.

Would you have done this differently if you had it to do over?
We always believed that GSM had limitations in terms of its capabilities. And as it's turned out, while Europe got credit in the early days for being ahead of us, [it's] been late to the party with smartphones. While AT&T beat us, because Apple picked them on smartphones, they had trouble with their network. So our view is we've done pretty well. We have a great 3G network and the beginning of an evolution on 4G.

As a journalist–and a customer–you'll find this hilarious: 90 percent of the traffic on the Internet in five years will be video. We're sitting in a position to say that between our global Internet backbone, our FiOS [residential fiber-optic network], and now our nationwide wireless network, we're in a position to put all the video that anybody wants to put on any tablet, on any device, any television set ... anything they want. So we can have a lot of fun in the short term banging heads with AT&T, but in the long term it's going to open up a new market and allow us to work with a great company like Apple to help us develop products.

Having presided over this, was it hard for you to have to make a deal with Apple in which your logo's not going to be on the phone?
No. I'm fine with that, simply because–I want to make sure I say this right, because I don't want it to come out wrong–we get a lot of customers on the Droid devices, so I think we've already proven that we're more than a one-device company. We're going to work our tail off to do a great job on the iPhone. But I think we're going to continue to do a great job on the BlackBerry and a great job on the Droid.

You're going to retire this year.
I'm going to retire, yes.

How are you going to deal with being on the cutting edge of technological change and just hand the keys to someone else?
I just got a letter in the mail that the pioneers of the Bell system will celebrate their 100th anniversary in 2011. ... I've worked here for 45 years. I've been CEO for 15. McAdam is a really, really good guy, and he's 56 years old. For me to stay ... it's almost a little selfish. Ⓑ



Watch Charlie Rose on Bloomberg TV weeknights at 8 p.m. and 10 p.m.

Verizon currently charges $30 a month for the unlimited plans on other smartphones, with voice and text messages costing extra. That's $5 more than what AT&T charges its heaviest data users, who can download up to 2 gigabytes of data per month. For those who like to stream *The Daily Show with Jon Stewart* while in line at Costco, $5 may be a small price to pay.

Quality: It's hard to know whether AT&T deserves the battering it has received for poor network quality. Each carrier's coverage differs from area to area. AT&T increased its investment in wireless infrastructure by over $2 billion in 2010, and says it's improving. As of last August, however, the percentage of dropped calls on AT&T's network had risen to 5.8 percent, compared with 2 percent for Verizon, according to a survey by Changewave Research. Infonetics Research co-founder Michael Howard says AT&T is more conservative with its network investments and took longer to upgrade from copper wires to fiber-optic cables and other cutting-edge gear. "Verizon planned its network with greater foresight than anyone else," says Recon Analytics analyst Roger Entner. "They have a very well-built network, and they don't cut corners."

5.8%

Calls dropped on AT&T, nearly three times the proportion on Verizon

Features: The carriers' iPhones are nearly identical, but where they differ, AT&T has the advantage. Verizon's network is based on a technology called CDMA, which runs voice and Internet over different tracks. That means Verizon's iPhone owners won't be able to surf the Web or use apps while on a call. AT&T users can, and the company says that more of its customers use the simultaneous talk-and-surf capability every day than watch videos or use GPS navigation.

Verizon users can, however, pay extra to transform their iPhone into a Wi-Fi hotspot, and share its cellular signal with up to five other gadgets. AT&T's iPhones currently link up with only one other gadget, and connect with them via a more limited Bluetooth signal.

Speed: A big part of AT&T's

CLOCKWISE FROM LEFT: JULIE JACOBSON/AP PHOTO; DAVID PAUL MORRIS/BLOOMBERG; BRAD TRENT

promotional pushback against Verizon is that its network is faster. Thanks to recent upgrades, AT&T boasts speeds of 6 megabits per second–fast enough to download a song in four or five seconds, and roughly three times what most Verizon subscribers see. Yet that speedy connection is available only in regions where AT&T has finished upgrading the wires that connect cell towers to the Internet, a process that won't be finished until at least 2013.

Future Proofing: The Verizon iPhone will likely have a short stint in the spotlight. Every year since 2008, Apple has announced a new, upgraded iPhone in early summer. Buying a Verizon iPhone in February likely means missing out on a sleeker version in a few months' time–although that's always a worry when buying gadgets.

Both AT&T and Verizon are building next-generation 4G networks with turbocharged speeds. Neither existing iPhone works on them, but analysts expect Apple to introduce a 4G iPhone within a year or so. Verizon is much further along–its 4G service is already available in 38 cities–so its service is a better bet for those hoping to upgrade to 4G speeds as early as possible.

Of course, the iPhone matters not just to Verizon's customers but also to its investors. No one doubts that winning Apple's "Jesus phone" will increase Verizon's subscriber base. UBS Securities expects the company to win 3.5 million new customers in 2011, while AT&T, **Sprint**, and **T-Mobile** will lose around 1 million between them.

Managing that growth won't be simple. Verizon is expected to pay $5 billion or so to subsidize new iPhone owners this year, which could drag down profit margins. Walter Piecyk, an analyst at brokerage firm BTIG, expects the opposite. He says the iPhone bonanza will allow Verizon to spread fixed costs like stores and TV ads across more units, boosting margins from 46.4 percent last year to 48.1 percent in 2012. If Verizon's network can handle the new subscribers, he says, it will further damage AT&T's brand. "They've had the iPhone for four years, and they're still trying to catch up with demand."
—*Peter Burrows*

***The bottom line** AT&T must now compete with Verizon for iPhone customers. The latter offers a more reliable but slower network.*

Innovator

Stephen Quake





The Stanford bioengineer has created a rubber chip that makes gene research faster, easier, and more precise

The microchip revolutionized electronics, making computations faster and cheaper. Stephen Quake says his "microfluidic chip" could help do the same for drug discovery, prenatal testing, and other genetics applications.

"We think about it as the biological equivalent of the integrated circuit," says Quake, a 41-year-old bioengineering professor at Stanford University. His chip dramatically streamlines genetic research: An experiment that would have required a week and 18,000 steps using standard lab equipment can be done in three hours and 200 steps.

Today, scientists deciphering DNA must painstakingly place samples and reagents into trays, wait for reactions, and then repeat the process over and over. Quake's chip automates this. Its key component is a series of tiny rubber valves that can be pinched closed by pressurized gas to form tiny chambers. Quake and researchers in his lab came up with the recipe for the valves while he was teaching at Caltech in 1998. The following year he co-founded Fluidigm to figure out how to manipulate tens of thousands of chambers, each about the size of a dot of ink, on a patch of silicone rubber smaller than a saltine. Instead of filling trays repeatedly, scientists load Fluidigm chips with samples and reagents, and a countertop controller automatically fills the rubber chambers with every possible combination.

The chips, which Fluidigm makes in Singapore, assist in work that requires looking for hundreds of genetic variations in hundreds of samples. The Alaska Fish & Game Dept. uses them to manage salmon runs. Because salmon are genetically programmed to return to spawning spots, researchers can use gene analysis to predict where they're headed. They catch salmon on their way to breeding grounds, punch holes in their fins, treat the tissue to isolate strands of DNA, and then run the samples through Fluidigm's chips. The technology screens samples fast enough to predict the course of whole salmon populations and guide fishing fleets.

"There's tremendous upside for this technology," says Kevin Davies, the author of *The $1,000 Genome*. Fluidigm's chips have shown promise for developing less-invasive forms of prenatal testing, for instance, by screening the minute quantities of a fetus' DNA found in the mother's blood. Fluidigm's customers–primarily universities, national labs, seed companies, fish and game managers, and drugmakers–pay $400 to $900 per chip.

Quake has made headlines for genetics technology before. In 2009 he used a machine of his own invention, the $1 million HeliScope, to analyze his DNA and become the eighth person to have his genome decoded. As Davies puts it, Quake "has already guaranteed himself an entry in the genome history books." Ⓑ —*Ira Boudway*

Education ▶ **A Stanford grad with a PhD in physics from Oxford**

Invention ▶ **A rubber chip that takes the grunt work out of gene research**

Application ▶ **Alaska uses the chips to predict salmon runs**

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Others ask how the market did today. We ask, "Which one?"

21°N – Jeddah, Saudi Arabia

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Contents ▶ JPMorgan's enormous legal tab 37 ▶ Morgan Stanley has something to prove 38 ▶ Why a housing recovery won't lift the economy 39 ▶ Reverse convertibles: A complex investment that flopped 40 ▶ Bid & Ask: Warhol + Mao + Dennis Hopper = big bucks 41 ● Edited by Eric Gelman

Markets&Finance

A Winning Stock Strategy: Sell on the Rumor

▶ **Companies named as acquisition targets typically deliver disappointing returns**

▶ **Although the reports "tend to create a pop, it's a very short-term event"**



The surest way to profit from takeover speculation in the stock market is to bet it's wrong.

Bloomberg examined 1,875 rumors about pending buyouts of 717 companies from 2005 to 2010 and found a total of 104 of those companies were acquired. While stocks that were the subject of takeover speculation initially jumped, they tended to decline over ensuing weeks. An investor who sold such stocks short–selling borrowed shares in hopes of buying them back at a lower price later–would have earned average profits of 1.2 percent over the next month, an annualized gain of 14 percent.

It's a strategy John S. Orrico has used. "We see it as an opportunity to sell if we think the rumor is false or ridiculous, which in most cases" it is, says Orrico, who focuses on mergers and acquisitions at New York-based Water Island Capital, which oversees about $2.2 billion.

Opportunities to employ the strategy are increasing as the stock market climbs and merger activity picks up. The number of unconfirmed stories about possible mergers surged to 611 last year, a 71 percent increase from 2009, data compiled by Bloomberg from more than 50 news providers and brokerages show.

Stocks tracked by Bloomberg gained 2.9 percent on the day they were mentioned in a takeover story. They fell 0.2 percent, 0.6 percent, and 1.2 percent, on average, in the day, week, and month following a reported rumor. The Standard & Poor's 500-stock index rose 0.03 percent, 0.2 percent, and 0.5 percent, on average, during the same periods. That makes sense to Todd Salamone, an equity analyst at Schaeffer's Investment Research in Cincinnati, who says that by the time market chatter is publicly reported, it's been passed around trading desks via instant messages and e-mail and is usually old news. While "the rumors tend to create a pop," he says, "it's a very short-term event."

Akamai Technologies has been the subject of more buyout rumors than any other U.S. company since the beginning of 2005, Bloomberg research found. The provider of computing services that speed delivery of Internet content remains independent after being named 21 times. The most recent instance was Dec. 16. After rallying 1.7 percent when the speculation was reported, shares of the Cambridge (Mass.) company lost 3.8 percent in the next week, while the S&P 500 gained 1.1 percent. Spokesmen for all the companies in this story mentioned as takeover targets either declined to comment or did not respond to requests for comment.

Akamai Technologies has been named in takeover rumors on at least **21** occasions. It is still independent.

NetList, a computer memory systems maker, rose 1.9 percent, to $5.52, when rumors were reported on Dec. 28, 2009 that **Microsoft** might buy it. The shares declined 2.2 percent a day later, 9.4 percent a week later, and 31 percent in 30 days. "NetList makes memory modules that go into servers, so Microsoft is not the type of company that would want to go and buy them," says Richard Kugele, an equity analyst at Needham & Co. "There's a difference between hardware companies and software companies, and it's just completely outside the bounds of what they do."

Even when they coincide with other bullish signals, rumors usually don't prove accurate. The volume of call options in **Jefferies Group**–giving the holder the right to purchase the stock at a certain price–jumped amid unconfirmed takeover reports on Feb. 27, 2008. A deal never occurred, and Jefferies stock plummeted 3.4 percent the next day and 10 percent the next week. It had fallen a total of 20 percent 30 days later.

Some stocks are acquired after years of speculation. **OSI Pharmaceuticals** was the subject of takeover talk nine times from 2005 to 2009, and the shares slipped on eight of those occasions. The stock

"The question that remains unanswered is: Where does the takeover story originate?"

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jumped 52 percent on Mar. 1, 2010, the day Tokyo-based **Astellas Pharma** said it would begin a hostile offer. There's no record of any takeover rumors in the days leading up to the announcement. Astellas bought OSI on June 9.

Many rumors are losers from the start. **MetroPCS Communications**, the wireless network, lost 1 percent on Sept. 21, 2009, after a news service reported chatter about a potential bid. The stock fell 34 percent over the next month and 49 percent for all of 2009, when the shares posted the fourth-biggest retreat in the S&P 500.

"The question that remains unanswered is: Where does the takeover story originate?" says Michael McCarty, managing partner at Differential Research in Austin, Tex. "It's most likely from someone who's interested in selling." Deliberately spreading false rumors may violate securities laws, especially if the intent is to sway prices, says James D. Cox, a professor at Duke University School of Law. Proving a market manipulation case is difficult, according to Peter J. Henning, a law professor at Wayne State University and a former federal prosecutor. "You might be able to see a unicorn before you see a market manipulation case established based on rumors," he says, adding that it is difficult to prove that someone started a rumor and then traded on it. "You get lots of investigations announced and very few cases brought," he says.

Overall, Bloomberg found that companies mentioned in takeover rumors were no more likely to be acquired than any other company. The safest strategy might be to avoid investing on gossip entirely. "Don't chase rumor stocks," says Michael Vogelzang, chief investment officer at Boston Advisors. "You never know where you are in the chain, whether you're the first to hear it or the last. You're just playing with fire." —*Tara Lachapelle*

***The bottom line** Stocks that are the subject of takeover rumors jump, then fall, making short sales a winning strategy. Ignoring rumors works, too.*

Litigation

Big Banks with Big Legal Tabs

- Mortgages, Madoff, and Lehman may add to JPMorgan's burden
- "They're similar to the asbestos or the tobacco industry"

The legal bills from the 2007-09 financial crisis keep rolling in, and they're starting to get ugly. **JPMorgan Chase** and other big banks face billions of dollars in legal costs related to their role in the financial crisis, threatening their profits and the stock price gains they made in 2010, analysts say.

For the first nine months of 2010, JPMorgan, the second-biggest bank by assets, reported $5.2 billion of legal costs, which can include reserves for losses and payment of judgments. **Bank of America**, the largest U.S. bank, and **Citigroup**, ranked third, are also besieged by lawsuits stemming from the credit crisis, brought by plaintiffs ranging from homeowners who were foreclosed upon to institutional investors whose mortgage-backed bonds turned out to be money losers. "They're under legal attack," says Richard Bove, an analyst at Rochdale Securities in Lutz, Fla. "They're similar to the asbestos or the tobacco industry, and they're going to be repeatedly sued in the next few years."

JPMorgan's third-quarter net profit of $4.4 billion, up 23 percent from the previous year, would have been larger if it hadn't set aside $1.3 billion for lawsuits and $1 billion for mortgage repurchases. Legal costs will rise if the bank reserves money for multibillion-dollar lawsuits by Lehman Brothers and the trustee liquidating Bernard L. Madoff's firm. The bank used the word "litigation" about 50 times in its latest Securities and Exchange Commission quarterly filing.

Litigation "ain't going away," Chief Executive Officer Jamie Dimon told analysts in an Oct. 13 conference call. "It's becoming a cost of doing business." Stephen Cutler, JPMorgan's in-house lawyer, declined to comment.

Bankrupt Lehman is suing JPMorgan for $8.6 billion in collateral it says was wrongly seized, plus tens of billions of dollars in damages, while Madoff trustee Irving Picard is demanding $6.4 billion on the grounds that the bank aided and abetted the biggest Ponzi scheme in history. JPMorgan is fighting both suits. Almost nine pages of JPMorgan's latest SEC quarterly filing deal with legal issues. They range from home foreclosure probes by state officials to shareholder lawsuits against Bear Stearns, which JPMorgan bought in 2008, and suits from nine



FROM LEFT: WHITE PACKERT/GETTY IMAGES; PHOTOALTO/ALIX MINDE/GETTY IMAGES

worldmags

Federal Home Loan Banks demanding compensation for mortgage-backed securities bought from JPMorgan, Bear Stearns, or Washington Mutual Bank, also purchased in 2008.

JPMorgan has been taking larger reserves than some rivals, according to company filings. Both JPMorgan and Bank of America disclose more information about their legal expenses than Citigroup or **Wells Fargo**, which don't give litigation cost totals in their regulatory filings. Shannon Bell, a spokeswoman for Citigroup, and Mary Eshet, a Wells Fargo spokeswoman, declined to comment.

Concerns that investors aren't getting enough information to assess litigation risks spurred the Financial Accounting Standards Board to issue proposals last year that would force banks to estimate litigation losses and say how much they're putting aside.

Because of claims over bad mortgages, this may be the banks' worst year for legal expenses since 2005, when Citigroup and JPMorgan each spent about $2 billion to resolve a lawsuit accusing them of helping energy trader Enron hide billions of dollars in debt from investors.

Bank of America reported $1.2 billion in litigation costs for the nine months through Sept. 30, excluding fees to outside law firms. Cases for which Bank of America already has reserved some money may wind up costing the bank $400 million to $1.9 billion more than it has set aside, according to its latest quarterly filing. The bank's nine-month litigation cost of $1.2 billion is up from $477 million the year before. "Our litigation-related expenses are cyclical and are not attributable to a single factor," says spokesman Lawrence Grayson.

Citigroup tries to settle lawsuits rather than contest them, it said in a filing. The bank still faces €14 billion ($18.4 billion) of claims for damages resulting from the bankruptcy of **Parmalat**, Italy's largest dairy company, in 2003.

Dimon articulated JPMorgan's approach to lawsuits in the October analyst call. "When we're wrong, we're going to settle," he said, "and when we're right, we're going to fight."
—*Linda Sandler*

***The bottom line** As claims mount, legal costs are taking billions of dollars out of profits at JPMorgan and other banks.*



Gorman says retail investors' confidence and trading have picked up

MELISSA GOLDEN/REDUX

Wall Street

It's Showtime for Morgan Stanley

- The company failed to live up to expectations last year
- "There may be some steak ... but there's not much sizzle"

Morgan Stanley, which shifted strategy last year to rely more on its 18,000 brokers and less on debt-fueled risk taking, is still struggling to prove the new model works. The company failed to ride a surge in equity and bond markets in 2010, and its stock underperformed its industry average.

Shortly after taking the top job last January, Chief Executive Officer James P. Gorman said 2009 was a "year of transition" and that 2010 would be the "year of execution." Things didn't play out that way: Last October, Gorman, 52, said Morgan Stanley, the sixth-largest U.S. bank by assets, was still in a "transition period" and "remains a work in progress."

While Gorman declined to comment for this story, his October remarks didn't go unnoticed. "When a CEO says that, it means he knows he still has some near-term challenges and that he's very conscious of not trying to encourage unrealistic expectations," says Chris Kotowski, an analyst at Oppenheimer in New York. "To me, that's better than saying reassuring things and then not delivering."

Morgan Stanley, which reports fourth-quarter results on Jan. 20, posted $3.59 billion in net income in the first nine months of 2010. Analysts now expect it to close out the year with $4.47 billion, 14 percent short of what they forecast last January. Morgan Stanley's stock fell 8.1 percent in 2010, ending the year down 63 percent from its 2007 high. That compares with an 11 percent gain for the Standard & Poor's

500 Financials Index last year, along with a 13 percent advance for the Standard & Poor's 500-stock index. The shares have risen 3 percent so far this year as of Jan. 11. "You can't take a lot of positives out of only being down 8 percent," says Douglas G. Ciocca, managing director at **Renaissance Financial** in Leawood, Kan., which manages $2 billion, including Morgan Stanley shares. "There may be some steak at Morgan Stanley, but there's not much sizzle."

Gorman spent much of the year steering the company away from the risk-taking model embraced by Chairman and former CEO John J. Mack, and rivals including **Goldman Sachs**. Gorman relinquished control of hedge fund **Front-Point Partners** and indicated he may dispose of more hedge fund stakes. The company's fortunes are now tied more closely to the success of **Morgan Stanley Smith Barney**, the largest brokerage in the world by number of advisers and client assets. In the first nine months of 2010, Morgan Stanley got 39 percent of its revenue and 15 percent of its pretax profit from the brokerage unit, which includes Morgan Stanley Smith Barney and a private bank started last year to offer loans to brokerage clients. The brokerage unit provided 16 percent of revenue and 5 percent of profit in 2006.

Morgan Stanley bought a controlling stake in Morgan Stanley Smith Barney from **Citigroup** in 2009. Last year it faced continuing costs from unifying computer systems at the brokerage. It also had to deal with skittish investors. The unit pulled in $8.8 billion from clients through September, which meant it was likely to miss Gorman's target of more than $20 billion for 2010. In July the company cited the May 6 market crash that briefly wiped out $862 billion in equity market value for scaring away retail investors. For the first nine months of the year, the brokerage unit had a pretax profit margin of 8 percent, below Gorman's target of 15 percent.

Gorman said in December that retail investors' confidence has returned and trading has picked up. "This business will see improving margins and revenue growth as individual investors get re-engaged, which is in fact what we are seeing," he wrote in a memo to employees that was obtained by Bloomberg.

Another weak spot is revenue from fixed-income trading, which was 30 percent lower than that of any of its largest U.S. competitors in the first nine months of 2010. Morgan Stanley reduced headcount in the department and committed less capital to fixed-income and equity trading as part of its shift away from risk taking.

Poor trading results masked strength in investment banking, Morgan Stanley's oldest business, which accounts for 12 percent of revenue. In 2010 the company was both the top global underwriter of equity offerings and the top global adviser on announced mergers and acquisitions for the first time since Bloomberg began compiling data in 1999.

"I believe that our stock is meaningfully undervalued, and that there will be a huge inflection point as we demonstrate to investors that our client-focused strategy is working," Gorman wrote in the December memo. Now he will have to deliver. "There's nothing you can say that's going to convince people," says Oppenheimer's Kotowski, who has a buy rating on Morgan Stanley. "It's got to be the numbers. Gorman understands that. He's a very thoughtful and realistic guy, and I don't think he's under any illusions about what he has to do." —*Michael J. Moore*

The bottom line *In 2011 Gorman must demonstrate that his decision to lean more heavily on retail investors and less on risk taking was a smart move.*

78.4

BILLION DOLLARS

The Federal Reserve's payment to the Treasury last year, up 65 percent from 2009, on increased income from mortgage and Treasury securities it bought to boost economic growth.

DATA: FEDERAL RESERVE

Real Estate

Why a Housing Rebound Won't Lift the Economy

▶ While sales may pick up, foreclosures are a question mark

▶ "It's possible people will get off the fence"

The housing market may start crawling up from rock bottom this year. Even if it does, though, any rebound is likely to be anemic. "There's a good chance of a housing turnaround this year, but it's not going to be enough to give much help to the economy," says Karl Case, the co-creator of the S&P/Case-Shiller indexes that track U.S. home prices. "We're coming off 50-year lows, and we still have to deal with the foreclosure mess."

On Jan. 8, the Massachusetts Supreme Judicial Court upheld a judge's decision that two foreclosures were invalid because the banks seeking to foreclose didn't prove they owned the mortgages. Joshua Rosner, an analyst at research firm Graham Fisher, called the decision "a landmark ruling" that "is likely to open the floodgates to more suits in Massachusetts and strengthens cases in other states."

Delaying foreclosures impedes the housing recovery, says Mark Zandi, chief economist at Moody's Analytics. That's because as long as there is the threat of more foreclosed homes coming onto the market, buyers will be hesitant as they anticipate prices falling further. "By the end of this year the housing crash could be over," he says. "Or, if we see foreclosures pushed into next year, we might not see a recovery till the end of 2012."

Housing was the workhorse of the U.S. economy before the end of the real estate boom. So-called fixed residential investment, a measure of homebuilding activity, contributed half a percentage point to gross domestic product growth in 2004, an 18-year high that outstripped defense spending's contribution, according to data from the Bureau of Economic Analysis. In 2005, housing accounted for 6.1 percent of economic activity in the U.S. Last year inflation-adjusted investment in new homes probably

Healthy vending, big opportunity page 45 ▶



subtracted 0.17 percentage points from GDP, based on the average of 2010's first three quarters.

This year housing investment is expected to increase 9.6 percent, according to the median forecast of 30 economists at a symposium hosted by the Federal Reserve Bank of Chicago in December. That would still leave it at the second-lowest level in 15 years of BEA data, after 2010. The economists expect it to account for 2.6 percent of the economy.

New-home sales likely fell to 321,000 last year, the lowest going back to 1963, according to a forecast by **Fannie Mae**, and sales of existing homes may have fallen to 4.82 million. Final numbers for 2010 come out later this month.

Sales of preowned homes and the construction of new houses will increase in every quarter of 2011, according to estimates by the Mortgage Bankers Assn., the National Association of Realtors, Fannie Mae, and **Freddie Mac**. Home prices, which typically lag behind sales trends, will begin to recover by midyear, the forecasters say.

Resales are likely to reach 5.23 million at an annualized pace by the end of the year, up 10 percent from the current quarter, according to Fannie Mae. Home prices probably will start picking up in the third quarter, posting a 0.6 percent increase for the year, which would be the first advance since 2006, according to the mortgage company's forecast.

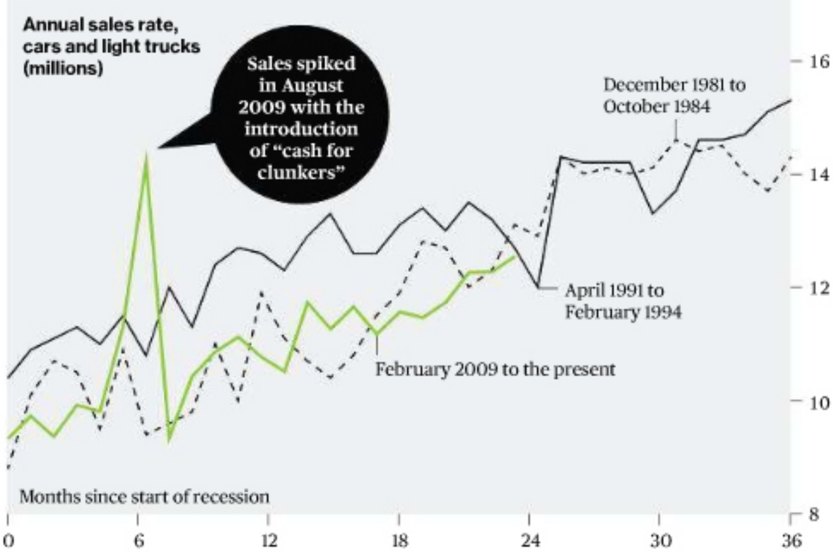
The market may improve more quickly if the economy continues to expand, says Case. GDP grew at a 2.6 percent rate in 2010's third quarter, up from 1.7 percent in the prior period, the BEA said in a Dec. 22 report. The unemployment rate fell to 9.4 percent in December, the lowest in 19 months, according to the Bureau of Labor Statistics. "If the economic recovery keeps going and unemployment keeps improving, it's a mood changer," said Case. "It's possible we could see people get off the fence and get back into the market." —*Kathleen M. Howley*

***The bottom line** While forecasters expect housing activity to increase, they don't think it will make a significant contribution to economic growth.*

Auto Industry

Return to Cruising Speed

U.S. auto sales may be back to a "normal" 15 million to 16 million rate by yearend, says James W. Paulsen, Wells Capital Management's chief investment strategist. The current rebound is tracking recoveries after the 1981-82 and 1990-91 recessions. —*Dave Wilson*



DATA: BLOOMBERG

Personal Finance

A Stock-Bond Hybrid That Flopped

▶ Promising high yields, reverse convertibles burned many buyers

▶ "Here's an asset class that's basically failed on all counts"

Banks sold more than $6 billion of bonds linked to the performance of stocks last year, promising returns of as much as 64 percent at a time when interest rates were at historic lows. Instead of delivering such extraordinary gains, reverse convertibles, as the products are known, lost 1 percent on average in the first 11 months of 2010, according to data compiled by Bloomberg. The Standard & Poor's 500-stock index returned 8 percent during that period and corporate bonds gained 11.1 percent, including reinvested interest, Bank of America Merrill Lynch index data show. "Here's an asset class that's basically failed on all counts," says Glenn H. Tongue, a money manager at T2 Partners in New York. "I doubt these are being pitched as an opportunity to lose 1 percent."

Reverse convertibles, which are marketed to individuals by some of the country's largest brokerages, are typically short-term bonds that convert into stock if a company's share price plummets. In effect, an investor who buys a reverse convertible is actually selling a put option—the right to sell a company's stock at a certain price. Investors also take on credit risk because the notes are unsecured debt.

Sound complicated? That's part of the problem. Individuals attracted by the high interest rate may not understand how the notes work, says Marilyn Cohen, who oversees $325 million as chief executive officer of Envision Capital Management in Los Angeles. "This isn't something that a retail investor calls up and asks for," she says. "Is it ever explained ... that you might end up with the stock and there's a large probability that will happen?"

It did happen to Leroy and Carol Conklin, a retired couple in Sun City Center, Fla., who say they were told about reverse convertibles by James Tuberosa, a broker at **H&R**

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Block Financial Advisors whom they met at their retirement community's annual FunFest fair. They bought some from Tuberosa in 2007 and 2008, they say, including $20,000 of notes linked to home improvement retailer **Lowe's** that paid 9 percent and that the broker called corporate bonds. "I said, 'Boy, this is a good investment,' " says Leroy Conklin, 80.

After a drop in Lowe's share price, the Lowe's notes converted into stock worth $4,000 less than the Conklins had paid for them, says Jason Doss, the Conklins' lawyer. He puts the Conklins' total loss on all the reverse convertibles they bought at about $130,000. The Conklins filed an arbitration claim against **Ameriprise Financial**, which bought H&R Block's financial advisory business in 2008. A hearing is scheduled for May. Tuberosa, who works for Ameriprise in Sun City Center, declined to comment, as did Benjamin Pratt, an Ameriprise spokesman.

The 1 percent average loss figure for reverse convertibles was calculated from Bloomberg data on 1,481 of the securities sold in the U.S. last year that matured by Nov. 30. Buyers profited on 75 percent of the notes. The average return was negative because investors lost more on the unprofitable ones than they gained on those that made money. One problem is that small investors would need a computer model and access to options pricing data to see if they're being compensated fairly for the risks they're taking, says Charlie O'Flaherty, who used to oversee U.S. structured products and derivatives at Bank of Ireland.

–1%

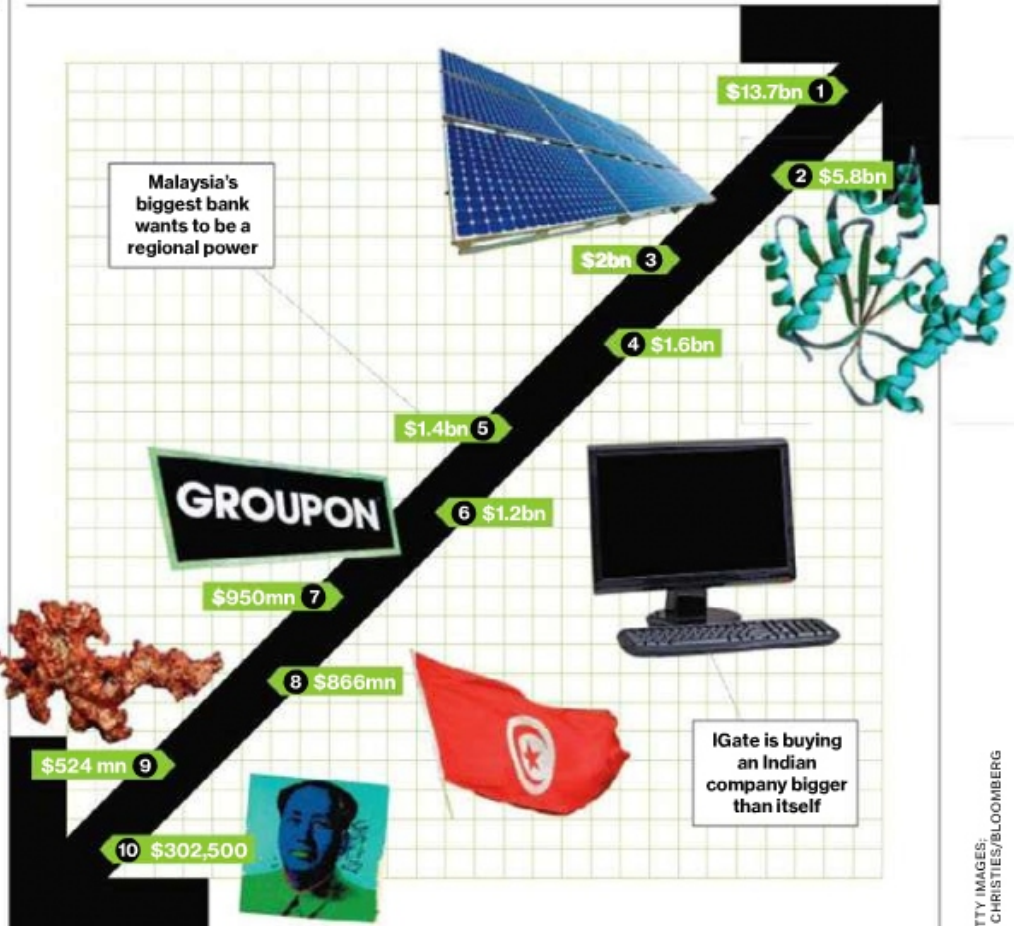
The average loss on reverse convertibles for 2010, through November

Kenneth Lench, head of the Securities and Exchange Commission's structured products unit, said in a September interview that the agency was examining whether brokers overcharged investors for the notes. He declined to comment for this article. Reverse convertibles, says Envision's Cohen, are "really a toxic product." —*Zeke Faux*

The bottom line *Lured by the prospect of high interest rates, individuals are buying reverse convertibles, a risky investment they may not understand.*

Bid & Ask

by Cristina Lindblad



1 **Duke Energy** is buying Progress Energy in a $13.7 billion deal that will create the largest utility in the U.S. The pace of power industry mergers has picked up as companies seek to add customers to counter falling prices.

2 **DuPont** offered $5.8 billion for Danisco, besting rival offers for the Danish maker of enzymes used in the manufacture of food and biofuels.

3 State-run **China National BlueStar** is buying the silicon businesses of Norway's Orkla for $2 billion. The People's Republic aims to become the world leader in solar and other low-carbon technologies.

4 **Nielsen Holdings,** the company that pioneered TV audience ratings, is seeking to raise $1.6 billion from an initial public offering scheduled for Jan. 25.

5 Malaysia's largest lender, **Malayan Banking,** bid $1.4 billion for Singaporean brokerage Kim Eng Holdings to enlarge its footprint in the region.

6 **IGate,** based in Fremont, Calif., offered $1.2 billion—more than its own market value—for control of India's Patni Computer Systems, in a bid to boost sales in the world's largest technology outsourcing market.

7 **Groupon** completed a $950 million round of financing that values the daily coupon website at about $4.75 billion.

8 Vienna-based **OMV** is buying Pioneer Natural Resources' oil exploration and production rights in Tunisia for $866 million.

9 Canada's **HudBay Minerals** paid $524 million for control of Norsemont Mining. Norsemont is developing a large deposit of copper in Peru. The metal's price recently hit a record high.

10 An **Andy Warhol** print of Mao Zedong that the late actor Dennis Hopper shot up during some late-night carousing in the 1970s fetched $302,500—10 times the presale estimate—at a Christie's auction.

CLOCKWISE FROM LEFT: COCO MCCOY/RAINBOW/GETTY IMAGES; TIM BOYLE/BLOOMBERG; ROBERT KOHLHUBER/GETTY IMAGES; DR. MANUEL C. PEITSCH/CORBIS; DANIEL HURST PHOTOGRAPHY/GETTY IMAGES; VALERY HACHE/AFP/GETTY IMAGES; CHRISTIES/BLOOMBERG



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Focus On **Enterprise**

Junk Food-Free Vending Machines Go to School

▶ **A new law boosts startups aiming to offer healthier fare to students**

▶ **"I can't even tell you the response we're getting"**

Jeff Lowell, an assistant principal at Interlake High School in Bellevue, Wash., normally dismisses the e-mails he gets from businesses trying to sell to his 1,500 students. He was intrigued, however, by the pitch he received in September from **Fresh Healthy Vending**, a San Diego franchise operation that offers vending machines stocked with snacks and drinks it touts as alternatives to junk food. "Everybody [understands] what eating right does for you and how much it ends up affecting your ability to think," Lowell says. "We decided we wanted to try it."

Lowell signed a one-year contract allowing Fresh Healthy to park its machines near Interlake's gym in exchange for 15 percent of profits. In late November, Fresh Healthy installed three machines, featuring goodies such as Kashi granola bars and Stonyfield Farm fruit smoothies, next to older machines that sell Powerade and Dasani water—though no soda—through a long-standing agreement with **Coca-Cola Enterprises**. The top seller in the new machines so far: Pirate's Booty cheese puffs.

Fresh Healthy is one of more than a dozen small companies that aim to bring healthier fare to school vending machines. To do so they must navigate a tangle of rules created in the wake of a 2004 federal law that required school districts to establish local policies aimed at improving student nutrition and reducing childhood obesity. Those rules prompted the bulk of the 10,500 U.S. vending machine companies to avoid schools. "There were fewer and fewer operators handling school accounts because it was a tough process to find products that met the patchwork of school guidelines," says Ned Monroe, senior vice-

➜



Snacks include carrots and other fresh veggies

Pirate's Booty cheese puffs are the best seller

Smoothies and juices offer an alternative to soda

PHOTO-ILLUSTRATION BY: STEVE CAPLIN FOR BLOOMBERG BUSINESSWEEK; CHIPS: PETER GONZAGA/PACIFIC RIM PHOTO/NEWSCOM; SMOOTHIE: MICHAEL NEELON/ALAMY; CARROTS: EARTHBOUND FARMS

Enterprise

China's mystery stocks page 58 ▶



president for government affairs for the National Automatic Merchandising Assn. The trade group estimates that just 10 percent of its vending operator members sell in schools now, down from about 25 percent a decade ago.

The hodgepodge of local policies will soon be replaced. Under a law that regulates schools participating in the federal school lunch program, which President Barack Obama signed on Dec. 13, the U.S. Agriculture Dept. now can impose nutritional standards on all snacks and refreshments sold in schools. The national guidelines will make it easier for vending companies to sell to many local districts. Producers are likely to be more willing to make foods suitable for vending machines if they know what requirements they must meet. "Food companies [are] trying to be ahead of the game and have products in the marketplace available to meet those standards as soon as they're published," says Diane Pratt-Heavner, a spokeswoman for the School Nutrition Assn., a trade group of food companies and school cafeteria managers.

1,500

Schools with Fresh Healthy's vending machines

Small vending machine operators that specialize in healthy snacks are confident the new law will boost their business. "I can't even tell you the response we're getting since this latest piece of legislation passed," says Fresh Healthy founder Jolly Backer, who launched the company in May to sell and supply franchises. He charges franchisees about $11,000 per machine, which they then manage, ordering from Fresh Healthy online and restocking once or twice a week. Fresh Healthy has machines in more than 2,000 locations, about three-quarters of them schools. "Our race is to get space," says Backer, 55. "A lot of schools would just as soon get rid of vending programs because they haven't found out about healthy options yet." He expects revenue at the 22-employee company to at least double this year, to more than $10 million.

Sean Kelly, the 27-year-old chief executive of **Human Healthy Vending** in Los Angeles, says the new law will help him expand from 300 machines to perhaps 1,500 by yearend. He hopes to convince schools that the vending machine business isn't "synonymous with scam" and that it sells more than junk food. Kelly expects revenue to triple this year, to more than $9 million. "We see tons of opportunity," he says.

The biggest U.S. vending machine operators—**Canteen**, **Sodexo**, and **Aramark**—have started offering healthier food in recent years. Canteen has a fledgling operation of about 200 machines (out of a total of 300,000) selling vegan foods and local fare. Since 2003, 15 percent of the products in its company-owned machines have met Canteen's reduced fat and sugar criteria. In 2001, Sodexo introduced a similar program for 20 percent of its products. The company says it plans to increase healthy choices to 30 percent by April. Aramark followed suit in 2005 with a labeling program showing nutritional values for products in its machines.

The new entrants say they aren't worried about industry giants muscling in on their niche. "I don't get that concerned about it because of the uniqueness of what we do," says William H. Carpenter Jr., president of **Vend Natural** in Annapolis, Md., which counts USDA headquarters among the locations for its 535 healthy vending machines. He says the company's revenue, "well north of $10 million," is on track to increase by more than 25 percent this year. "The growth is just so huge," Carpenter says, "not only because of what's happening under the current Administration but just how people want to eat." —*Nick Leiber*

The bottom line *Clearer legislative standards have been a boon to companies that provide schools with vending machines selling healthier fare.*

Audits

The Taxman Cometh: Keep Your Head (and Revenues) Down

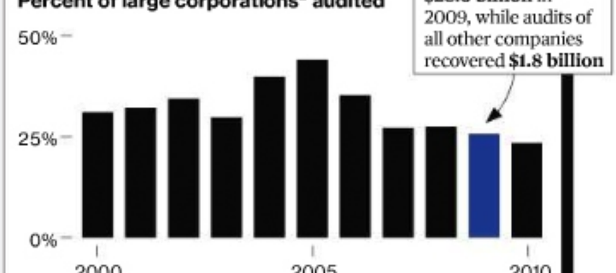
The majority of IRS business audits hit small companies because they far outnumber big ones. Large corporations and wealthy individuals, though, stand a much greater chance of being audited. —*John Tozzi*

Chances of being audited

Probability		Audits (FY 2010)
14.2%	Corporations with assets over $10m	10,207
8.4%	Individuals earning over $1m	32,494
2.7%	Individuals earning $200,000–$1m	120,481
1.1%	All individuals	1,581,394
1.0%	Individuals earning under $200,000	1,428,419
0.9%	Corporations with assets under $10m	19,127
0.6%	All businesses	58,067
0.4%	S corporations and partnerships	28,733

Sole proprietors of small businesses have an audit rate of 2.6%

Percent of large corporations* audited



Money recovered per hour spent auditing



DATA: IRS, TRANSACTIONAL RECORDS ACCESS CLEARINGHOUSE REPORTS *ASSETS OVER $250M

CLOCKWISE FROM TOP LEFT: NICK M. DO/GETTY IMAGES; WHITNEY CURTIS/BLOOMBERG; CHRIS OBERHOLTZ/KANSAS CITY STAR/MCT/LANDOV

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Brewing

Challenging Bud On Its Home Turf



▶ Upstart brewer Schlafly has gotten a lift as locals rue InBev's takeover

▶ "The environment during that time was, 'You're lucky to have one tap'"

When Tom Schlafly started making craft beer two decades ago in Anheuser-Busch's hometown of St. Louis, local bar owners gave the brewer a standard response on sales calls: "We already stock all the beers." In local parlance, that meant Anheuser-Busch's full lineup, not just Bud and Bud Light. "It was kind of like selling a foreign car in Detroit," says Schlafly, president of **Schlafly Beer**, "almost like heresy."

That's starting to change. Anheuser-Busch's 2008 takeover by Belgium's **InBev** has undermined loyalty going back generations in St. Louis, where the U.S. King of Beers has been based since its founding in 1852. That fissure and the nationwide renaissance of microbreweries are leading some St. Louis drinkers to call Schlafly their new hometown brew. Today, a total of 2,000 taps serve the beer, up more than 30 percent in the past two years. "Now there's a bit more ambivalence about AB: They're just another major world company," says Mike Sweeney, 31, who runs a beer blog called STL Hops.

Until a few months ago, Schlafly's draft beer was available at just one concession stand at Busch Stadium, home of baseball's Cardinals. Now that's up to eight because of growing interest in the brew, says Dan Fetcho, a regional director for **Delaware North**, which controls beer sales at the stadium. Never mind that the ballpark was named for Anheuser-Busch's founding family and that the company owned the Cardinals until 1996—or that the organist still plays a Budweiser jingle during games. "Schlafly is a local flavor that has become more and more mainstream," Fetcho says.

Schlafly (a nephew of Phyllis Schlafly, founder of the conservative Eagle Forum) started brewing in 1991, when Anheuser-Busch was the sole beer producer in a city that a century ago was home to scores of breweries. He borrowed money to finance the endeavor, using Anheuser-Busch stock as collateral. "I loved the irony," says Schlafly, 62, who is still a partner at St. Louis law firm Thompson Coburn.

Schlafly teamed up with Dan Kopman, the son of one of his law partners, who was working for a small brewer in London. The pair set up a brew pub three miles from AB headquarters in a pair of burned-out red-brick buildings on Locust Street, a blighted neighborhood that served as a set for the 1981 film *Escape from New York*. "They laughed at us when we first opened—a microbrewery in St. Louis?" says Kopman, 49, who owns a fifth of the company. (Schlafly owns three-quarters; a few friends have the rest.)

The fledgling brewer put up a sign in Busch Stadium on the Cardinals' opening day so fans could find the beer. The next day, the sign was gone; Anheuser-Busch had exclusive rights for advertising beer in the stadium. "The environment during that time was, 'You're lucky to have one tap,'" says Kopman, who oversees day-to-day operations at the brewery. "We just needed to shut up about it."

Kopman says the company got a lift when InBev bought Anheuser-Busch two years ago. Within weeks the new owners cut about 1,400 U.S. jobs, three-quarters of them in St. Louis. In 2009, Schlafly's beer sales jumped nearly 30 percent, to 31,000 barrels, as revenue grew 17 percent, to $11.6 million.

Roughly 90 percent of Schlafly's sales are in the St. Louis area, and the rest goes to cities within about 300 miles.

Schlafly is the new hometown brew for a growing number of St. Louisans



Schlafly has 1.5 percent of the St. Louis market, vs. InBev's 68 percent, says Kopman, who can look up from his desk to see steam rising from an Anheuser-Busch brewery in the distance. It helps keep things in perspective: That single AB facility cranks out 16 million barrels of beer a year, or 60 percent more than the entire U.S. craft beer industry, from Samuel Adams down to small fry such as Schlafly. "Size becomes less of a goal, because you're never going to

Speed Dial
Brett King

The author of *Bank 2.0* discusses how banks can remain relevant to small business owners

What's the biggest banking problem for small biz customers?
Service. At the moment, banks are saying, "You're lucky to be our customer. Come to us if you need something." Business owners are saying, "We have other options." [Twitter co-founder] Jack Dorsey's startup **Square** is a great example of mobile payments innovation where the banks are being too slow to adapt. Software companies and other virtual financial institutions are taking over the relationship banks traditionally had with borrowers.

How will small business banking change over the next decade?
Small businesses are particularly challenged by payments and cash flow. It will be increasingly important for banks to simplify the mechanism of receiving payments. Instead of waiting for a check to clear, they might be able to instantly receive a payment from a customer using a phone. Ninety percent of small business accounting is probably wrapped up in bank transactions. There's going to be some merger between Internet banking and Quicken-like accounting functions.

Will that integration improve lending to small businesses?
As information flow increases and banks know more about a business, the risk is reduced. At the moment the problem is, "I don't understand your business well enough to anticipate whether you can afford credit." As banks start to adopt innovations, it may be easier for them to assess creditworthiness. That may make them more inclined to lend—or if a business is clearly a risk, to communicate why and help fix it.
—*Nick Leiber*

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be as big as they are," Kopman says.

As its grip loosens, InBev is by no means forfeiting St. Louis. The company says its market share in the city is stable, though it declines to provide any numbers. And the brewer's share in sports stadiums remains "exceptionally strong," says David A. Peacock, president of Anheuser-Busch. "We have a strong bond with St. Louis and the people here, and they return the sentiment," Peacock says.

For now, Schlafly is fighting for distribution one tap at a time. This season the beer became available at the Edward Jones Dome, home of the National Football League's St. Louis Rams. "It's like people are finally realizing that there is more than just Bud," says Mark Schwartz, a season-ticket holder sipping a Schlafly while watching the home team take on the San Diego Chargers. "It's unbelievable how it has caught on."
—*Angie Lau and Duane D. Stanford*

The bottom line *As loyalty to Budweiser in St. Louis slips after the takeover of Anheuser-Busch, upstart brewer Schlafly has seen its sales jump.*

Credit

A D&B Spin-Off for The Internet Age

▸ The new venture vows a break from "fear-based" sales of credit reports

▸ "What we're trying to do now is show a holistic picture"

The Dun & Bradstreet brand has been synonymous with credit reports for most of its 159-year history. To business owners like Marilyn Landis, though, the name also means hard-sell pitches for information few businesses need. Her Pittsburgh financial consulting firm, **Basic Business Concepts**, got a call from D&B in December with a warning that another business had requested the company's credit file. The caller suggested that Landis' business might look risky to vendors if she didn't pay to update her credit report with revised financial data. "What it's doing is scaring small businesses," says Landis, the former chair of the National Small Business Assn.

Jeff Stibel hopes to change all that by remaking Dun & Bradstreet for the Internet Age. He became chief executive officer of the division of **D&B** that sells credit reports to the smallest businesses when the parent company sold the unit to a private equity group in August. Stibel wants **Dun & Bradstreet Credibility Corp.**, as the new venture is called, to move beyond credit ratings and start helping businesses manage their reputations online. "What we're trying to do now is show a holistic picture" of what makes a business appear trustworthy, he says. "Credit is just one component. ... D&B's largest competitors these days are **Google**, **Facebook**, and **Twitter**."

D&B compiles credit files on private companies from public records, payment information supplied by vendors, and self-reported data such as financial



performance. The company sells that data to corporations that use it for marketing and to evaluate credit risk. Revenue at the small business division, which charges companies to rate their creditworthiness, was declining by double digits under D&B's ownership. Stibel acknowledges he has to approach customers in a new way. "There was a fair amount of fear-based selling, and that's something that we are trying to dramatically change," says Stibel, a 37-year-old entrepreneur who most recently ran a website-services company called Web.com.

20
MILLION
U.S. companies in D&B's database

Credibility Corp.'s first new offering will collect comments and reviews from sites such as Twitter, the Better Business Bureau, **Yelp**, and **Citysearch**. Stibel says he hopes to launch it in the first half of 2011 and eventually wants to have such profiles for each of the more than 20 million companies in D&B's U.S. database. Stibel thinks mom-and-pop businesses that don't have the time or resources to track how they're perceived online will pay Credibility Corp. $300 to $900 a year to manage those profiles. The new business is growing by double digits and is on pace to reach sales of $100 million in its first year, Stibel says.

The spun-off company, with more than 400 employees, raised some $200 million from Boston private equity group **Great Hill Partners**. Credibility Corp. will pay D&B undisclosed licensing fees for using the company's brand and database. Stibel says the business suffered from neglect under D&B, since it made up less than 6 percent of D&B's 2009 sales of $1.7 billion. D&B declined to comment, but on an earnings call in July, D&B CEO Sara Mathew called the division a "critical drag" on her core operation of selling credit data to larger corporations. "They were not going to invest in that business," says Shlomo Rosenbaum, an analyst at brokerage Stifel Nicolaus.

Because many small business transactions aren't reported to D&B, a company's file may make it look riskier than its complete payment history would, says Doug Palmer, a Bethesda (Md.) accountant. Few businesses or lenders consider D&B records essential for credit decisions, Palmer says. Like Landis, he advises clients not to pay for D&B products unless a specific creditor requires it. "Vendors and suppliers ... would much rather see financial statements and [check] trade references" than buy D&B reports, he says.

That's why Stibel is exploring ways to help companies manage their reputations beyond credit. "Businesses are confused and paralyzed," he says, "because they don't know where to start" managing how they are perceived online. Ⓑ
—*John Tozzi*

The bottom line *A spin-off of D&B aims to move beyond just credit reports and help small businesses track their reputations online.*

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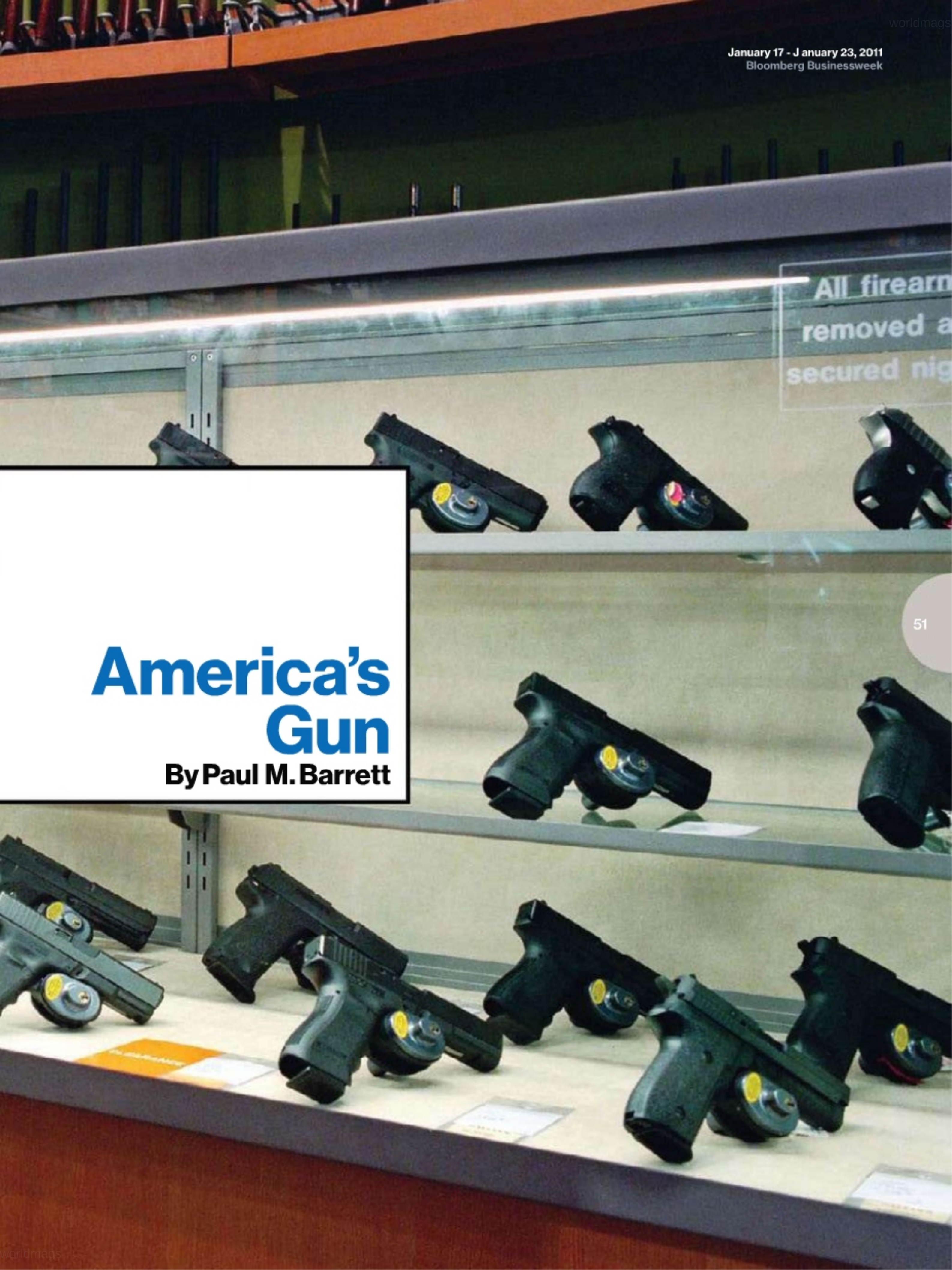
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How Austria's Glock became the weapon of choice for U.S. cops, Second Amendment enthusiasts, and psychopaths



America's Gun

By Paul M. Barrett



The crime scene in Tucson. In the days after Loughner allegedly used his high-capacity Glock to kill six and wound 14, sales boomed in Arizona

For all the anguish and outcry in the days after a community college dropout named Jared Loughner allegedly sprayed a Tucson crowd with 33 bullets from a semiautomatic pistol, one response was notably absent: any sense that America's latest shooting spree, which killed six people and wounded 14, including Representative Gabrielle Giffords, would bring new restrictions on the right to own or carry large-capacity, rapid-fire weapons.

The gun control debate has vanished from American politics, but it wasn't always so invisible. Twenty years ago, when another apparently deranged man fired a semiautomatic pistol into a crowd, killing 23 people in Killeen, Tex., politicians rushed the microphones to denounce the weapon itself as "a death machine," as Representative John Conyers Jr., a Michigan Democrat, put it on the floor of the House. A so-called assault weapons ban became law three years later. That law has now expired. Since Loughner's attack, liberal pundits, gun control advocates, and congressional backbenchers have been talking about instituting new controls. The voices that count, however, including President Barack Obama and the congressional leaders in both parties, have had nothing to say on the subject.

Their silence is just one measure of how thoroughly Gaston Glock—a former curtain-rod maker from Austria whose company manufactured the pistols used in Tucson and Killeen—has managed to dominate not just the American handgun market, but America's gun consciousness. Before Glock arrived on the scene in the mid-1980s, the U.S. was a revolver culture, a place where most handguns fired five or six shots at a measured pace, then needed to be reloaded one bullet at a time. With its large ammunition capacity, quick reloading, light trigger pull, and utter reliability, the Glock was hugely innovative—and an instant hit with police and civilians alike. Headquartered in Deutsch-Wagram, Austria, the company says it now commands 65 percent of the American law enforcement market, including the FBI and Drug Enforcement Administration. It also controls a healthy share of the overall $1 billion U.S. handgun market, according to analysis of production and excise tax data. (Precise figures aren't available because Glock and several large rivals, including Beretta and Sig Sauer, are privately held.)

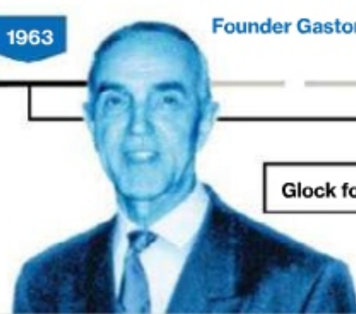
With all those customers and that visibility, it's no surprise that the Glock

PREVIOUS SPREAD: BRIAN ULRICH/NOTIFBUTWHEN; THIS PAGE: TONY BLEI/POLARIS

A Man and His Gun: The Story of Glock

1963

Founder Gaston Glock



Glock founded in Austria to make curtain rods and other

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has also been the gun of choice for some prolific psychopaths. Byran Uyesugi used a Glock 17 to kill seven people at a Xerox office in Honolulu in 1999. Seung-Hui Cho, who murdered 32 at Virginia Tech in 2007 before killing himself, used the same Glock 19 model that Loughner is accused of firing in Tucson. Steven Kazmierczak packed a Glock 17 when he shot 21 people, killing five, at Northern Illinois University in 2008.

The smooth-firing Glock did not cause these massacres any more than it holds up convenience stores. But when outfitted with an extra-large magazine, it can raise the body count. The shooters in Arizona, Illinois, Virginia, Hawaii, and Texas could not have inflicted so many casualties so quickly had they been armed with old-fashioned revolvers. In its 2010 catalog, the manufacturer boasts that while the Glock 19 is "comparable in size and weight to the small .38 revolvers it has replaced," the pistol "is significantly more powerful with greater firepower and is much easier to shoot fast and true."

The Tucson gunman demonstrated those qualities all too vividly. Loughner is said to have emptied his 33-round clip in a minute or two, a feat requiring no special skill. (Glock does not sell magazines of that size to civilians, but some of its guns can accommodate them. The model 19 comes with a standard 15-round clip.) Loughner was wrestled to the ground by onlookers only when he paused to insert a fresh magazine. If he had been forced to reload sooner, the odds are good there would be fewer victims. Glock executives did not respond to multiple requests for comment.

Loughner seems to have had no trouble acquiring his Glock and its oversized magazines, and, for an array of reasons, it's unlikely the harrowing crime will lead to any new curbs on Glock's efficient brand of firepower. For that the company can thank a remarkable chain of unintended consequences—including gun control opponents who fueled public interest in Glock and gun control laws that boosted sales. The more gun foes tried to ban or curb Glock's weapons because of their potency, the more the company turned those attacks to its advantage. Even the tragedy in Tucson has been a boon. Bloomberg News reported on Jan. 11 that $499 Glocks were selling briskly in Arizona. "We're doing double our normal volume," said Greg Wolff, owner of a pair of stores in Phoenix and Mesa called Glockmeister.

For decades until the early 1980s, Gaston Glock ran a radiator plant in suburban Vienna. On the side, he manufactured window fittings and bayonets in his garage, using a second-hand Russian metal press. Now 81 and living reclusively at a lakeside resort in southern Austria, Glock got his start in guns by listening closely to the customer.

In 1980 the Austrian Army was looking for a new sidearm to replace the antiquated Walther P-38. Steyr, Austria 's premier arms maker since the mid-1880s, offered a clunky update which tended to misfire. Glock, though he had no firearm expertise, saw an opportunity. He studied the best pistols available and consulted with leading European firearm experts. "We sit together and made the plan and drawing," he recalled in a March 1998 legal deposition in the U.S. "It was like a pistol in the future."

The Army colonel in charge of procurement wanted a pistol that was light, durable, and capable of holding more than the eight rounds the Walther accommodated. Glock solved the puzzle with plastic. He fabricated a frame from an injection-molded polymer, a featherweight material that proved remarkably strong and corrosion-resistant. In the evenings he tested crude early versions in a basement firing range. He shot alone, using only his left hand, so that if the gun blew up he would still have his right to do mechanical drawings. In 1981, Glock filed for an Austrian patent—his 17th, so he called the gun the Glock 17. Coincidentally, it could store 17 rounds in its clip, with an 18th in the chamber. In competitive trials for accuracy and durability in 1982, the Glock defeated models made by Steyr and four other well-known European arms manufacturers. The Austrian military ordered 20,000, and Gaston Glock had cracked the gun business.

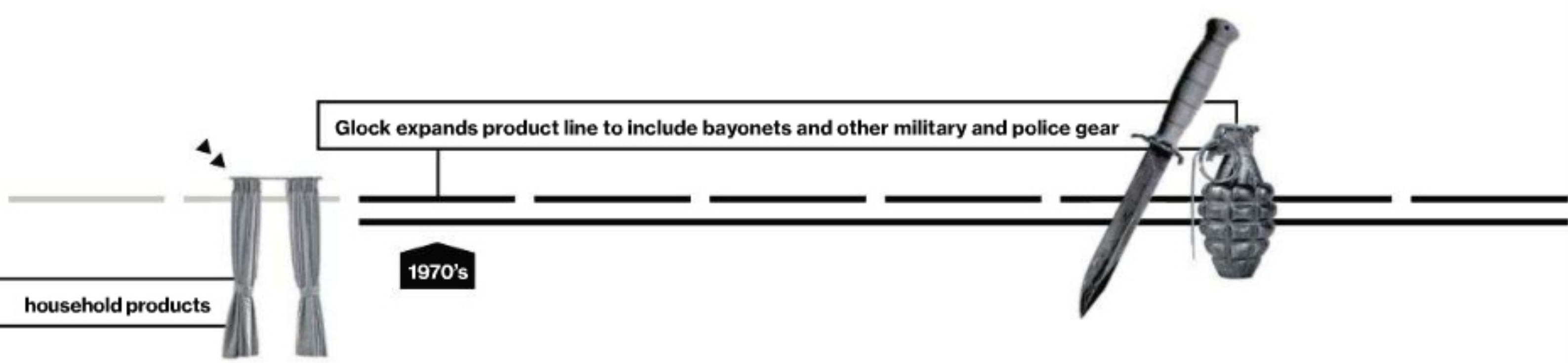
When Karl Walter, a firearm salesman based in the U.S., first picked up a Glock during a visit to a Vienna gun shop in the spring of 1984, his reaction was, "Jeez, that's ugly." The squared-off pistol lacked the blued-steel frame and polished wooden grips of a classic American revolver. Its black matte finish seemed homely. "But still, I was extremely curious why the Austrian Army bought it," Walter says. "There had to be more to it than what meets the eye initially."

A native Austrian, Walter sold imported rifles to American police departments, traveling from town to town in a motor home custom-fitted as a rolling gun showroom. For years he had nurtured an idea about handguns: "Where there really is money to be made is to convert U.S. police departments from revolvers to pistols."

Ever since the 19th century, when the Colt Peacemaker became known as "the gun that won the West," Americans had preferred revolvers. Continental Europeans favored pistols, also known as semiautomatics, with spring-loaded magazines that snap into the handle, holding more rounds and allowing faster reloading. "I was astonished," Walter says, "that this modern country still hung around with revolvers." In 1984 he paid a call on Gaston Glock and offered to sell his pistol in America.

They made a complementary pair: Glock, the reticent engineer, unfamiliar with the U.S. and its taste

TIMELINE: ALAMY(2); WEAPONS SPECIALISTS LTD(1)



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in guns, had a breakthrough product. Walter, the garrulous expat, had valuable connections in the world's richest gun market. In 1985, Walter set up Glock's American subsidiary in a small warehouse-and-office complex near the Atlanta airport in Smyrna, Ga. He launched at the perfect time. A year later, America's police collectively decided they needed a new handgun.

With violent, cocaine-driven crime on the rise—the U.S. gun homicide rate increased 39 percent between 1983 and 1993—police saw themselves as outgunned. There was little statistical support for this; the typical police gunfight at the time involved the firing of two to three rounds by the cops—well within the capacity of a Smith & Wesson revolver. The number of officers killed in the line of duty had peaked in 1974 at 279 and declined to 178 in 1986. But in several notorious incidents, including a shoot-out in Miami in April 1986 that left two FBI agents dead, the bad guys deployed more firepower than the law enforcers. "Although the revolver served the FBI well for several decades, it became quite evident that major changes were critical to the well-being of our agents and American citizens," FBI Director William S. Sessions said after the Miami bloodshed.

Walter garaged his RV and began zooming around in a Porsche, pitching the Glock to force after force. In late 1986 the Miami Police Dept. ordered 1,100 pistols, followed closely by Dallas, San Francisco, and others. "It's the wave of the future," said the chief in Minneapolis, who authorized Glocks for his officers. In December 1986, Curtiss Spanos, a cop in Howard County, Md., fired 16 rounds in a 30-minute pursuit of two armed robbery suspects. The Glock saved his life and his partner's, he told the *Washington Post*. "There would be two dead officers if I didn't have the 9 millimeter gun."

At that time, gun control advocates trying to thwart the Austrian invader made their first strategic misstep. They claimed that because it was mostly plastic, the pistol would be invisible to X-ray machines. "Only the barrel, slide, and one spring are metal," the late Jack Anderson wrote in his syndicated column in January 1986. "Dismantled, it is frighteningly easy to smuggle past airport security." Antigun groups mobilized, Congress held hearings, and the National Rifle Assn. rallied its troops. "The amazing thing was that nobody had ever heard of Glock before the Anderson column," says Richard Feldman, a lawyer then working for the NRA. " 'Glock? What's that? Oh, an Austrian gun, a plastic gun? Interesting. I've got to see one of those.' "

As the 17-round pistol became an object of curiosity and admiration among Second Amendment enthusiasts, the anti-Glock campaign fizzled. The Federal Aviation Administration concluded that if screening personnel paid attention, they would be able to detect the pistol. "That was a big 'oops' moment," says Richard M. Aborn, a former president of Handgun Control Inc., now known as the Brady Campaign to Prevent Gun Violence. "We made the classic mistake of failing to do our homework."

Hollywood, never known for accuracy, gave Glock another boost. In *Diehard 2: Die Harder*, released on July 4, 1990, mercenary terrorists swarmed the big screen armed with Austrian pistols. The hero, played by Bruce Willis (who carried a Beretta), at one point yelled at an airport police captain: "That punk pulled a Glock 7 on me! You know what that is? It's a porcelain gun made in Germany. It doesn't show up on your airport X-ray machines, and it costs more than you make here in a month." It didn't matter that everything the Willis' character said was inaccurate, says Feldman, the industry operative who later did consulting work for Glock. "You had Jack Anderson, and Congress, and now Bruce Willis—everyone's making things up about Glock. And gun owners, they want to defend the 'porcelain gun' or the 'plastic gun' or the 'hijacker special,' or whatever the media are calling it. What fabulous publicity."

In September 1994, after a string of grisly shootings—the 1989 Stockton (Calif.) elementary school attack, the 1991 Killeen massacre, the 1993 Waco siege—

The Clinton-era assault weapons ban seemed likely to hurt Glock. It had the opposite effect



1982

Glock wins contract to manufacture 9mm pistols for the Austrian Army

Bloody FBI shoot-out in Miami crystalizes idea that

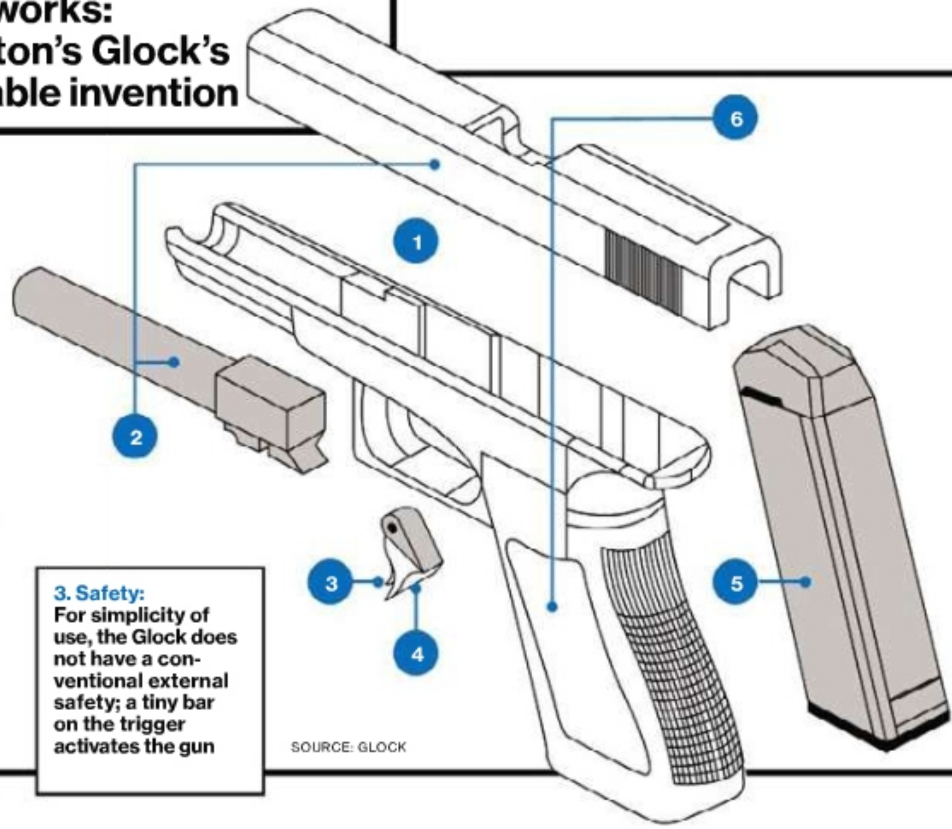


Glock makes Hollywood debut in action

TIMELINE: ALAMY(1); EVERETT COLLECTION(1); GETTY IMAGES(1); POLARIS(1)

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The Glockworks: Inside Gaston's Glock's utterly reliable invention



1. Design: With only 34 parts in total, the Glock is far simpler than most comparable guns and less likely to have mechanical problems

2. Finish: Tenifer, as Glock calls the high-tech surface treatment of its steel barrel and slide, has tremendous hardness and durability

3. Safety: For simplicity of use, the Glock does not have a conventional external safety; a tiny bar on the trigger activates the gun

4. Trigger: The light, consistent pull weight (5.5 pounds) enhances accuracy

5. Capacity: The design accommodates large clips in many models, giving the user more firepower without having to reload

6. Polymer: The frame is made of corrosion-resistant plastic that is 86 percent lighter than steel

SOURCE: GLOCK

Congress passed the assault weapons ban, which President Bill Clinton immediately signed. The law, which limited magazine capacity to 10 rounds, seemed likely to hurt Glock. It had the opposite effect. Long before the law's enactment, Glock was running its factory at full tilt. "We're getting 5,000 guns and 8,000 to 9,000 magazines a week from Austria," Dick Wiggins, a Glock representative, told the Minneapolis *Star Tribune* in May 1994. "We're tens of thousands of orders behind," he added. "Our pistols are scarcer than hen's teeth."

As a compromise to get the law passed, the Clinton Administration had agreed to allow continued sale of gear manufactured before the ban. Glock executives figured the new law would incite a buying frenzy, and they were right. "People who own guns that use magazines holding more than 10 rounds—including the Glock 9mm popular with police—are buying extra magazines as fast as they can," *USA Today* reported. "'We were cleaned out of magazines in the space of a few hours,' says Mike Saporito of RSR Wholesale Guns of Winter Park, Fla., which supplies thousands of retail shops. 'Sales have gone through the roof.'"

Seventeen-round Glock clips that had sold for less than $20 quintupled in price over the next few years. The unintended consequence of the law was that more high-capacity weapons and magazines ended up in stores, at gun shows, and on the street. Indeed, "the Clinton gun ban," as the NRA called the legislation, created a fascination with large clips that hadn't existed before in civilian gun circles.

The Austrian company found new ways to feed the demand the law had unintentionally created. Having supplied scores of major police departments with 9mm weapons in the late 1980s and early 1990s, Glock gave these agencies the opportunity to trade in their modestly used pistols for brand-new ones. The exchanges earned the company powerful customer loyalty and gave Glock another large batch of pre-ban magazines that could be resold on the burgeoning used market. In one exchange in late 1994, Glock received 16,000 used high-capacity clips and more than 5,000 older pistols from the Metropolitan Police Dept. of Washington, D.C.

Asked whether Glock was circumventing the magazine law, its in-house counsel, Paul F. Jannuzzo, sounded indignant. "It's not a way around the crime bill. It is well within the law," he told *The Hartford Courant*. "I'm not sure what the spirit of the crime bill was. I think the whole thing was an absolute piece of nonsense."

Glock also responded to the assault weapons ban by designing and

1986 — U.S. law enforcement needs more potent handgun



Glock appears in movie *Diehard 2* starring Bruce Willis

1990 — movie *Diehard 2* starring Bruce Willis

1991 — Tupac Shakur offers Glock profane rap tribute on his debut solo record, *2Pacalypse Now*

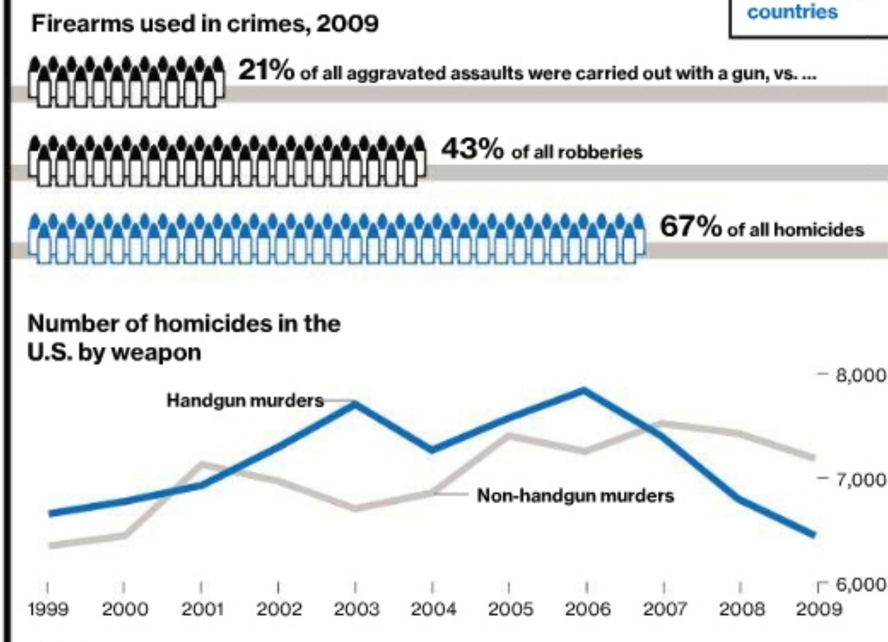
1991 — Killeen (Tex.) shooter uses Glock pistol in massacre of 22 people



1994 — Newly manufactured high-capacity magazines outlawed; Glock profits from stockpiled pre-ban clips

America's Heavily Armed Criminal Culture

The U.S. violent crime rate has fallen dramatically since 1993, but the nation still has a far higher level of gun crime than comparable industrialized countries



DATA: FBI

marketing a new generation of smaller handguns whose clips held 10 or fewer rounds—"Pocket Rockets," as Glock called them. In 1995 the company introduced the Glock 26 and Glock 27 in 9mm and .40 caliber, respectively. (The Glock model-number system tells one nothing about the nature of the weapons.) The barrel and grip of the new models were an inch shorter than standard Glocks, but the ammunition packed just as much punch. The guns could be conveniently tucked into a pocket or purse: "a perfect choice for women," Glock said in a press release.

At the same time, the NRA—a powerful and, for the industry, inexpensive lobbying arm that is funded mostly by gun-owner members—was stepping up a nationwide campaign in support of state laws that gave civilians the right to carry concealed handguns to shopping malls, Little League games, and almost anywhere else. Pocket Rockets were ideal for suburban concealed carry. Before 1987 only 10 states had right-to-carry laws. In 1994 and 1995 alone, 11 states enacted such statutes, bringing the total to 28. "The gun industry should send me a basket of fruit," Tanya Metaksa, the NRA's chief lobbyist at the time, told *The Wall Street Journal*. "Our efforts have created a new market." Today, 48 states allow concealed carry; only 10 of those require applicants to provide a reason. Arizona, Alaska, and Vermont do not demand any kind of permit at all.

As Glock grew, reaching sales in the U.S. of roughly $100 million by the late 1990s, according to two former company executives, the company had to withstand new courtroom assaults from municipalities allied with plaintiffs' lawyers who sued gunmakers the way states had gone after tobacco companies. Jannuzzo, the company's corporate counsel, gained influence, eventually taking the lead executive role in the U.S. once held by Walter, who had left over a compensation dispute.

A former prosecutor in New Jersey, Jannuzzo displayed a boxer's talent for jabbing and feinting while opponents tired themselves out. In 2000 he sent signals publicly and privately that Glock might agree to settle the municipal litigation then being orchestrated by the Clinton Administration. In exchange for protection from future liability, Glock and other corporate defendants would acquiesce to unprecedented marketing restrictions. At the eleventh hour, however, Jannuzzo rejected the deal, leaving Glock rival Smith & Wesson as the only industry participant. A retail boycott encouraged by the NRA nearly drove S&W out of business, while Glock reveled in a temporary sales surge.

The entire settlement collapsed in 2000 and became moot when a GOP-controlled Congress passed a statute in 2005 to protect gunmakers from such suits. Glock had played a risky game and won again. Lost in the process was a rare opportunity for an industry that makes inherently dangerous products to police their promotion and sale more vigorously.

The gun control movement was flagging long before 2005. In the closely contested Presidential election of 2000, Al Gore had lost his home state of Tennessee in part because of NRA opposition, and Democrats decided that gun control was a cursed issue. President George W. Bush made noises about extending the assault weapons ban and magazine limit, but when the NRA and Republicans on

56



Glock "Pocket Rockets" capitalize on NRA campaign to loosen concealed-carry laws

1995

1999-2000

Glock outmaneuvers Smith & Wesson in the face of lawsuits filed by U.S. municipalities

2000



In tight Presidential race, Al Gore loses home

Assault weapons ban and magazine limit

Capitol Hill resisted, he allowed the law to expire in September 2004.

Glock led the charge back into the large-capacity clip business. Other gun and accessory makers also pushed ever-larger magazines. Today, Sportsman's Warehouse in Tucson, where Loughner bought his Glock, advertises a 50-round "Tactical Solutions Drum Magazine" for .22 caliber Ruger rifles priced at $64.99. The store also sells Glock-factory magazines, designed for six to 17 rounds, at $29.99 apiece. The outlet's website notes, however, that "compact and subcompact Glock pistol model magazines can be loaded with a convincing number of rounds–i.e. ... up to 33 rounds." The online store CDNN Sports, based in Abilene, Tex., advertises 33- and 31-round Glock-compatible mags that it labels "Asian Military MFG." Only six states–California, Hawaii, Maryland, Massachusetts, New Jersey, and New York–now have their own limits on large magazines.

When Glock rolled out the smaller "Pocket Rocket," it called the gun "a perfect choice for women"

High-efficiency weapons make American criminals deadlier, and in extreme cases, such as Tucson, large magazines make them deadlier still. Compared with other industrialized Western democracies, the U.S. does not have an especially high level of crime, or even violent crime. What it does have is "a startlingly high level–about five times the Western European/Canadian/Australian average–of homicide," UCLA public policy professor Mark A.R. Kleiman writes in his 2009 book, *When Brute Force Fails*. The U.S. "also has an astoundingly high level of private gun–especially handgun–ownership," an estimated 100 million civilian handguns. Gun homicide rates are higher in the U.S., Kleiman argues, because robberies, residential burglaries, and aggravated assaults committed with guns are all more lethal.

Why, then, is all the movement on gun regulation toward more permissiveness? One key reason is that after rising from roughly 1963 through 1993, crime began to drop off. In 1993 there were 9.5 murders and non-negligent manslaughters per 100,000 inhabitants, according to the FBI's annual *Crime in the United States*. By 2009 that rate had fallen 47 percent, to 5 per 100,000. Offenses committed with firearms also fell sharply. The reasons are a matter of dispute. Possible factors include a sharp rise in the rate of incarceration, improved policing methods, and the burning out of rivalries among crack gangs. Gun control advocates credit point-of-purchase background checks and the assault weapons bill. More rigorous studies indicate that those laws actually had negligible effects on crime, according to Kleiman.

Polls show that even most people who support stricter gun control do not believe that such laws reduce crime generally. "At some basic level," Dennis Henigan, vice-president of the Brady Center to Prevent Gun Violence, acknowledges in his 2009 book, *Lethal Logic*, "the public is convinced that 'when guns are outlawed, only outlaws will have guns.' This belief cannot help but diminish the intensity of public support for further gun restrictions."

The rise of the Glock and other semiautomatic handguns cannot be linked to variations in overall crime rates. But that doesn't mean it would be pointless to take small steps to reduce mayhem, such as restricting magazine capacity. One lesson of Tucson is that there is a difference between a 33-round clip and an 8- or 10-round clip. The only way to make a limit work, though, would be to ban the manufacture, sale, and possession of all clips larger than the cap. Reviving a porous 1990s-style limit would backfire. Representative Carolyn McCarthy (D-N.Y.), among others, is working on a new restriction. "We are optimistic it will plug the loopholes in the 1994 law," says Kristen Rand, legislative director of the Violence Policy Center, a gun control group that is consulting on the bill. Even if quite modest, however, the provision seems unlikely to receive serious consideration in a Republican-controlled House of Representatives. Glock's victory, and that of its industry, won't be reversed anytime soon. B

–With Michael Riley

This article draws on Bloomberg Businessweek Assistant Managing Editor Paul M. Barrett's reporting for a forthcoming book on Glock and its influence in America, to be published by Crown in 2012.

TIMELINE: GETTY IMAGES(3); WEAPONS SPECIALISTS LTD(1)

state of Tennessee, thanks in part to the NRA

2004

expire; gun control fades as national issue



Virginia Tech gunman uses Glock in campus slaughter of 32 people

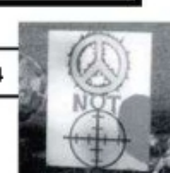
2007

2008

Glock turns up in hands of Northern Illinois University mass killer

2011

Tucson shopping mall shooter uses Glock to kill six and wound 14



You Will Regre

By Dune Lawrence
Photograph by Jamie Chung

How a retiree in Austin, Tex., uncovered a China-size fraud



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On an April afternoon in 2009, in his home office outside Austin, Tex., John Bird was hunched over his computer trying to figure out if a Chinese company some 6,500 miles away was anything close to what it claimed to be. Silver-haired and retired, Bird, 62, likes to project an air of relaxed amusement. His personal philosophy is reflected in a sticker from *The Big Lebowski* over his office door: "The Dude abides..."

Some things, however, Bird takes very seriously, including what he calls the "sanctity of math," which on that afternoon was being defiled in his eyes by the claims of China Sky One Medical, a maker of products such as "magnetizing" hemorrhoid ointments and patches that would "dispel fat." Sky One, according to its annual report filed just a few days earlier, was selling out of its inventory every seven days.

Bird's first business venture—before real estate development, a music venue called Club Foot, and a direct-mail marketing firm—was a chain of nine movie theaters in Austin in the 1970s. Audiences ate through stocks of popcorn and candy every three days or so, but supplies of cups and buckets took months to run through, adding up to an average turnover of eight to 10 days. Sky One's inventory, Bird figured, ought to move more slowly, since things like cardboard boxes for packaging and adhesives for patches are bought and stored in bulk and used bit by bit as orders come in.

They're turning their inventory over faster than a doughnut shop, thought Bird. Or, as he later put it, "It's like somebody telling you they just drove over here at 600 miles per hour. It's not going to happen."

Sky One, Bird would find, wasn't the only stock recently arrived from China, and it wasn't the only one seemingly exceeding financial speed limits. Sky One, which declined to comment for this story, is one of more than 350 small Chinese companies to have listed in the U.S. since 2004 through a process called a reverse merger, in which an operating Chinese company takes over an all-but-defunct publicly traded U.S. shell company.

The capital at stake is significant. Shares of such reverse mergers are held by many funds available to retail investors, including Oppenheimer Main Street Small Cap Fund and the PowerShares Golden Dragon Halter USX China Portfolio, and are scooped up by small-cap index funds. Roth Capital Partners, an investment bank in Newport Beach, Calif., that has been one of the most active in helping such Chinese companies raise money, recently tried to measure the Chinese reverse merger market. It came up with a list of 94 companies with market capitalizations of between $50 million and $1 billion that trade an average of at least 50,000 shares daily, with a total stock market value of more than $20 billion.

Bird's involvement would evolve from irritation that a company could get away with making a claim that so obviously defies basic business logic to the conviction that many pieces of the Chinese miracle that trade in the U.S. are, in his words, "flat-ass" frauds. And what started as a retiree looking into a company has turned into a dispute that has drawn in other shorts, the Securities and Exchange Commission, auditors, and, according to recent reports, the U.S. House Committee on Financial Services. It has also revealed significant flaws in U.S. markets and how they are regulated. Although the stocks trade on U.S. exchanges, and thus project a sense of having to play by American rules, the assets and the principals of many of the companies reside in China. The companies operate on their terms, leaving injured parties and the SEC powerless. Bird says the carnage is just beginning. "The whole thing has no place to go but to blow up," he says. "That's a rational position for an investor to start with, that every one of these Chinese reverse mergers is a fraud."

Bird didn't start out on a mission against Chinese stocks, but he doesn't believe in doing things by halves. His art collection includes a nine-ton copy of a Babylonian horse figurine from 600 BC that sits next to his pool and two six-foot-tall mosaic eggs that spin in the field beyond; those are two of 18 large sculptures that dot his 70-acre property northeast of Austin. His wife of 39 years, Jenny, gave him a backgammon set a few years ago, and he now travels to Las Vegas to compete in tournaments.

Bird has never been to China; his closest brush came on →

This
estment

Not everything from China is profitable

worldmags

a visit to Hong Kong in 1959. He came to shorting Chinese companies through a website run by Manuel P. Asensio. Now a financial adviser, Asensio was barred from the brokerage industry in 2006 by the National Association of Securities Dealers (now known as Financial Industry Regulatory Authority) for failing to cooperate with an investigation into misleading research reports. (The noirish world of short-selling is full of such compromised figures; Bird himself declared bankruptcy in 1985.) Asensio.com publishes short-selling ideas. It initiated coverage of Sky One in April 2009, questioning a history of restatements and frequent changes in auditors and sparking Bird's own investigation.

75%

Rise in Sky One's stock price in 2007, the company's second year in the U.S.

Sky One, Bird found, was a combination of Comet Technologies and American California Pharmaceutical Group. Comet Technologies was a "blank check" company, incorporated in Nevada, with no business other than finding a promising acquisition. American California Pharmaceutical Group was a holding company for Harbin Tian Di Ren Medical Science and Technology, which had been making over-the-counter medicines based on Chinese herbal remedies since 1994 in the northern city of Harbin. The shares of the new company, merged and renamed China Sky One Medical, finished 2006 at $8 and climbed 75 percent in 2007, to $14, as the company promised it was stepping upmarket from wart-removal spray to gene recombination techniques; the stock also likely benefited from the seemingly unquenchable enthusiasm for China's prospects. In 2008, Sky One moved from the OTC Bulletin Board to the American Stock Exchange and then to the Nasdaq Composite Index.

Bird turned up credit reports on Harbin Tian Di Ren from providers in Britain, India, and China. The numbers in all three matched each other, but they did not match the SEC filings. After two months of e-mails and phone calls, Bird reached a woman named Terry at Qingdao Inter-Credit Services, a credit report provider, who sent Bird the filings it used. They were from a Chinese agency called the State Administration for Industry & Commerce (SAIC). For Bird and those who followed him, the SAIC filings were "like getting X-rays of a terminal patient," he says. "It was dead stock walking."

The SAIC is the Chinese government agency responsible for market supervision, regulation, and enforcement. According to the filing, Sky One's operating unit, Harbin Tian Di Ren, had 2008 sales of 6.93 million yuan, roughly $1 million at 2008 exchange rates. Yet to the SEC, Sky One reported 2008 sales of $91.8 million, with Harbin Tian Di Ren accounting for at least 65 percent, or $59.7 million. Bird ordered reports to trace Sky One customers and suppliers; the paperwork showed companies too small to generate the orders or inventory Sky One posted.

By August 2009, Bird was ready to place a serious bet. From his home office, he logged on to his account and sold short 30,000 shares at $15.70. The natural next step of a short-seller is to get the word out, and Bird soon posted a selection of his evidence on the Web. Bird chose the URL waldomushman.com, Waldo Mushman being the occasional pseudonym of Steve McQueen, at least according to Bird.

Bird also sent his evidence to the SEC, to Sky One, and to Sky One's auditor, Cranford (N.J.)-based Moore Stephens P.C. (now known as MSPC Certified Public Accountants and Advisers). An SEC official in Los Angeles, Junling Ma, called him about the SAIC documents, as did a Nasdaq enforcement official, according to Bird. He also made regular posts to sites such as Seeking Alpha and Yahoo! Finance, arguing his case. None of it, at first, proved much of a setback for Sky One, whose price mainly climbed, along with Chinese shares in general.

But Bird's method of checking Chinese-American stocks through SAIC filings did interest other investors, who began to use it as well. This disparate, far-flung crew included short-sellers such as Andrew Left of Citron Research in Los Angeles, the eccentrically named Muddy Waters Research, based in Hong Kong, and Sahm Adrangi, a 29-year-old Yale graduate running tiny hedge fund Kerrisdale Capital in New York.

Listing in the U.S. through a reverse merger is easier than joining the main exchanges in Shanghai and Shenzhen, where local companies face a long waiting period and profitability requirements. A public market for startups, ChiNext, only started in October 2009. A Hong Kong listing on the Growth Enterprise Market also presents hurdles, with minimum thresholds for cash flow and expected market capitalization.

A U.S. reverse merger, by contrast, can take as little as three months and cost under $1 million in fees, according to CCG, a Los Angeles investor relations firm that specializes in Chinese companies. In 2010, 78 Chinese companies listed in reverse mergers, according to DealFlow Media figures as of Jan. 6, adding to the 294 that did so from 2004 through 2009.

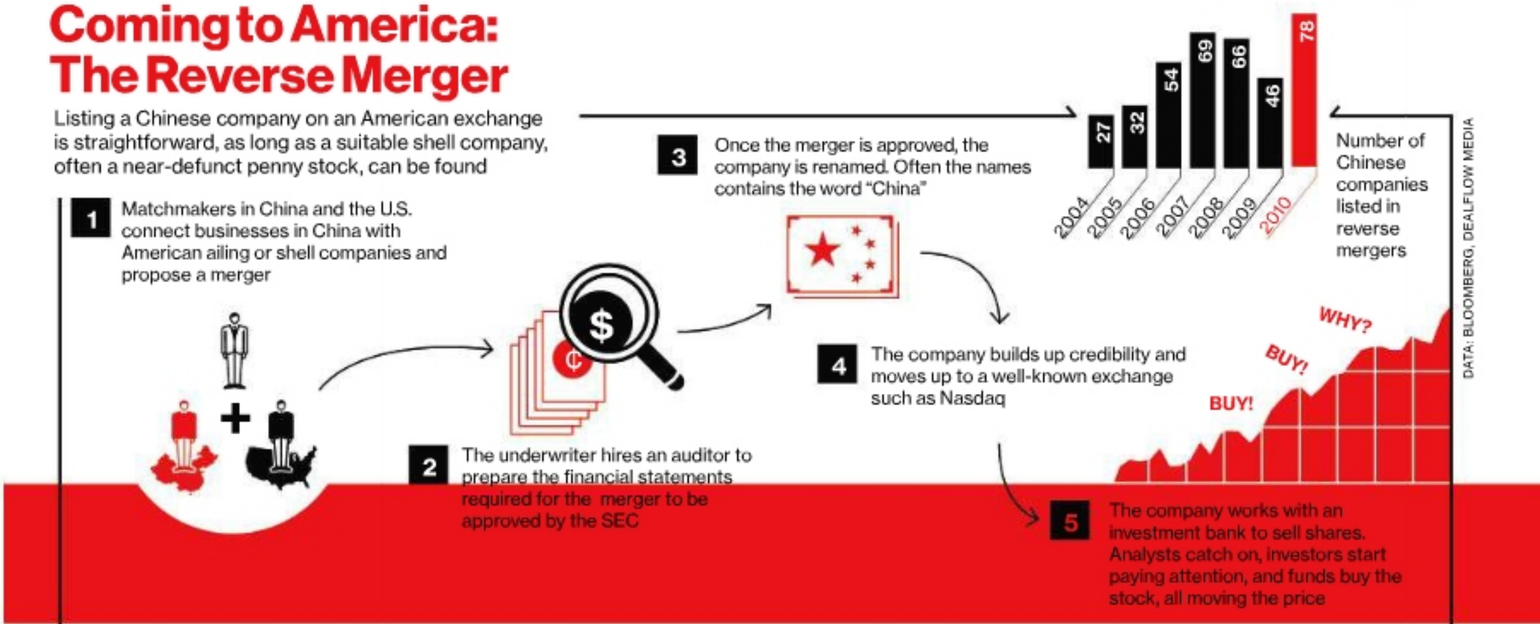
The Sky One deal cost between $600,000 and $800,000, according to Charles Hung Jr. of American Eastern Group, the Los Angeles investment firm that set it up. According to Hung, he and his father, Charles Sr., visited the company for more than a week to see the products on store shelves and meet the management. The company was led then and now by Chairman and Chief Executive Officer Liu Yan-qing. Liu's background was in drug marketing, journalism, and research and development, and he has a bachelor's degree from Harbin Medical University as well as an executive MBA from Tsinghua University, according to his biography on the company website.

Starting in the early 2000s, the Hungs engineered four Chinese reverse mergers, the last one for China Shen Zhou Mining & Resources in 2006, soon after Sky One's. In three of the deals, including Sky One's, the Hungs paired off the Chinese companies with shell company vehicles linked to Utah businessman Jack M. Gertino. Filings list Gertino as investing in real estate and having run a car tune-up franchise. He received 163,581 shares of Sky One, warrants for more shares, and a consulting deal for "financial and management planning" covering the two years after the merger. Gertino says he passed on dozens of deals before pursuing the China Sky One reverse merger, for which he visited the company in China twice. He adds that it's a "terrific" company.

The Hungs also paired Sky One with E-Fang Accountancy, a two-partner firm in City of Industry, Calif., that prepared two years of U.S.-audited financials. Hung remembers E-Fang as being "very thorough." In December 2008, the California Board of Accountancy suspended E-Fang's license for 30 days and imposed three years' probation for gross negligence and violating professional standards, without specifying which company work triggered the action. Hung now says that he wouldn't do a

Coming to America: The Reverse Merger

Listing a Chinese company on an American exchange is straightforward, as long as a suitable shell company, often a near-defunct penny stock, can be found



reverse merger unless the company agreed to a top 10 auditor.

Others in the business include Benjamin Wey, who has built a career bringing companies over from China and onto exchanges such as Nasdaq. Wey was born in China and likes to recount how he arrived in the U.S. in 1992 with $62 in his pocket and worked part-time as a Chinese chef while attending Oklahoma Baptist University. He now has offices on Wall Street, 60 employees in China, and says he accepts just 1 percent of the companies that seek him out.

Wey says that his clients don't want to wait to list at home, and a full-blown initial public offering in the U.S. is expensive and difficult, partly because banks don't want to underwrite tiny companies. "The reason these companies do reverse mergers is not because it's good or bad ... they have no alternative," he says.

From a 38th-floor conference room overlooking the silver and grey glints of lower Manhattan, he describes how a typical deal works: List via reverse merger with private funding from his company, New York Global Group, jump up to a name exchange such as Nasdaq, then raise much larger amounts of money with a secondary offering once the company has established credibility. He says he assigns up to nine Chinese local staff members to lead a company through seven to 11 months of due diligence before a U.S. listing. "There's a lot of traps to try to avoid," he says.

In 2007, the American Stock Exchange delisted a fertilizer company that Wey had brought over, Bodisen Biotech, for incomplete and inaccurate disclosures related to share ownership by officers as well as payments to Wey's company. The move came in the wake of a series of stories in the *New York Post* and MarketWatch. The Oklahoma Securities Dept. also censured Wey in 2005 for not advising customers of the risks of stocks he sold and not disclosing consulting relationships with some of the companies. Wey agreed to a ban on working in the securities business in the state without admitting to the allegations.

Bird was down almost $90,000. Instead of cutting his losses, however, he filed suit against China Sky One's auditor

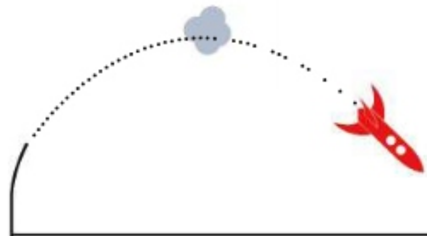
A couple of weeks after waldomushman.com went live, Sky One acknowledged that its SAIC and SEC filings were "materially different" but assured investors of the accuracy of its U.S. filings. Its shares slid gradually from almost $15 to under $12 by November, then began to climb again. Bird was disappointed.

"Here I put the SAIC documents out and I expect to shake the world, and nothing much happens," Bird says. "So I thought, 'This is going to take more effort.'" Bird found a private investigator in Harbin who charged $59 an hour to take photos of Sky One's facilities and investigate land records, which Bird hoped would turn up incriminating evidence. It didn't. He also began delving into the company's patents, which Sky One valued at $1.6 million in 2007. The same seven patents were valued at $15.1 million in 2008. In the meantime, Sky One shares rose to a high of $24.25 on Dec. 28, 2009. and ended the year up 42 percent.

The rise meant Bird needed cash to cover his losses, as brokerages call for a cushion or "margin" to ensure that short sales can be settled. At the time of the stock's climb, Bird was in New Zealand with his wife and, because of the time difference, had to make trades at 3 and 4 a.m. to cover the margin call.

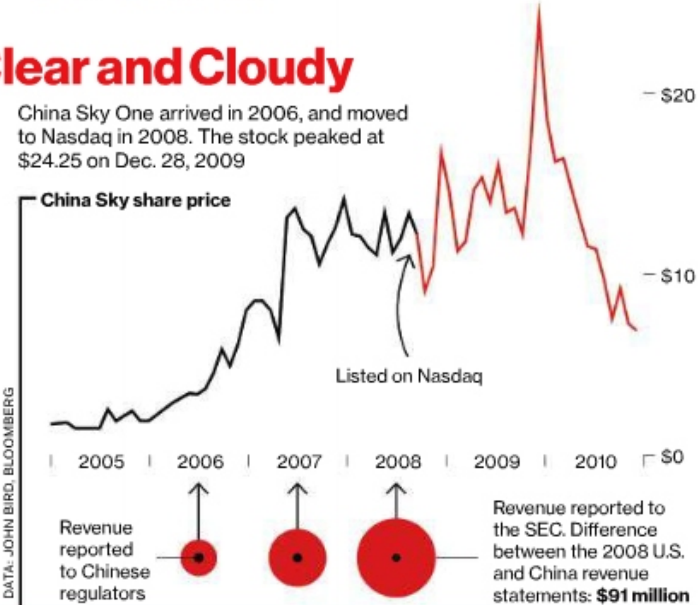
He returned home exhausted and down almost $90,000. Instead of cutting his losses, however, he filed suit in March against the company's auditor, MSPC, for failing to acknowledge misrepresentations in Sky One's financial statements and errors in its audit work. Bird didn't sue Sky One directly because the U.S. company's assets are in China. "I just got pissed-off, and I'm a stubborn man," he says. Michael G. Mullen, the head of MSPC's audit department, declined to comment on the ongoing litigation. MSPC audits three U.S.-listed Chinese companies and some that want to list, according to Richard J. Montalbano, a partner in the firm who focuses on China-related work. MSPC has had other problems in the field. In an April 2009 inspection report, the Public Company Accounting Oversight Board (PCAOB), part of the SEC, noted "audit deficiencies" in one case so significant that the team declared MSPC didn't have enough evidence to support its opinion on the issuer's financial statements.

By May 2010, other shorts began to emerge, waving SAIC filings, just like Bird. A Detroit forensic accountant,



Clear and Cloudy

China Sky One arrived in 2006, and moved to Nasdaq in 2008. The stock peaked at $24.25 on Dec. 28, 2009



Steven R. Chapski, citing Sky One, posted an analysis of the 2009 SAIC and SEC filings for another company, cable- and wire-maker Lihua International, on Seeking Alpha. Lihua responded by making its 2009 SAIC filing and a reconciliation with SEC filings available on its website. Lihua gained 7.6 percent last year, but Chapski continues to question the company. "It just doesn't add up, and I've never heard anybody tell me a good reason why my thinking is wrong," he says.

In June, Chinesecompanyanalyst.com, a blog run anonymously by Kerrisdale Capital's Adrangi, accused China Marine Food Group of fabricating SEC financial statements, citing SAIC documents that showed 2008 revenue 85 percent lower than reported in the U.S. Adrangi also questioned China Marine's acquisition of Shishi Xianghe Food Science and Technology in January 2010 for $27.8 million, pointing out that Xianghe's proprietary algae drink formula had been worth just $8,776 in 2009, when Xianghe purchased it. China Marine shares slumped 30 percent in June. The company says that for 2009 its SAIC filings were consistent with its U.S. filings.

In November, Adrangi went after China Education Alliance, an online education company. After meeting with its executives in August, he asked a Chinese friend to look at the company's website. Nonfunctional, the friend reported. So Adrangi followed in Bird's footsteps: "If there's any person who started this, it's John Bird," he says. "He's the reason anybody is looking at the SAIC filings."

Adrangi obtained China Education's SAIC filings and sent locals to look for its products in stores and to check out its training center. The allegations seemed, by then, familiar. Local SAIC filings showed online revenue of less than $1 million in 2008, vs. $16 million in revenue from "online education" in its SEC filings. The company also had a cast of four auditors in six years and financial metrics that strain credulity when compared with those of competitors. Adrangi's report, published on Nov. 29, sent China Education shares tumbling 39 percent in two days, helping his fund to a more than 30 percent gain for the month. China Education, whose stock has lost 59 percent in 2010, denied all the allegations made in the Kerrisdale report, launched a stock repurchase program, and filed documentation of its bank balances to the SEC.

In June 2010, Hong Kong research outfit Muddy Waters took on Orient Paper, a paper maker based in Baoding, Hebei province, whose stock had surged from 24¢ to $10.48 in 2009. Muddy Waters was the brainchild of Carson C. Block, a lawyer and founder of Love Box Self Storage in Shanghai ("Get Self Storage Without BS") who also consults for his father's company, W.A.B. Capital, which promotes small companies to investors.

Muddy Waters dove right in and said in a June 28 report that Orient Paper's "purpose is to raise and misappropriate tens of millions of dollars." The report accused the company of overstating its 2008 revenue by 27 times and 2009 revenue by 40 times. Orient Paper denied the allegations, but its shares plunged 40 percent in the four trading days after the report was released. They rebounded briefly and then dropped again as the company announced in August that it had retained law firm Loeb & Loeb to coordinate an independent investigation.

In November, the audit committee released summary findings that largely dismissed the Muddy Waters report, including the SAIC/SEC mismatch, but did not make the full investigation public.

Orient's audit committee chair, Drew Bernstein, says that short-sellers are just exploiting the ignorance of U.S. investors and the inexperience of Chinese executives. "You have these Chinese chairmen, when they take green dollars from the U.S., I don't think they fully understand the obligations and responsibilities that come with it," says Bernstein, of auditor Bernstein & Pinchuk, which represents 40 U.S.-listed Chinese companies. Coupled with U.S. investors who "can't find China on a map," it's a "perfect storm" for shorts, says Bernstein.

Like many U.S.-listed Chinese companies, Orient Paper was underwritten by Roth Capital, which responded to the short attacks with a primer that aimed to explain the SAIC filings. "Divergent PRC [People's Republic of China] filings and U.S. filings do not, in and of themselves, establish error, misstatement, or fraud," researchers John Ma and Mark Tobin wrote in a July 2010 report. "This data should be viewed as one aspect of a broader due diligence process."

Since 2003, Roth, run by three brothers from Iowa, has made U.S.-listed Chinese companies (not all reverse mergers) into fully 24 percent of its business, raising $3.1 billion in capital. Its annual growth conference last year attracted more than 1,000 institutional investors who got three days of access to 350 companies, including 100 U.S.-listed Chinese companies, as well as a Billy Idol concert and an IMAX screening of *Avatar*.

In the past year and a half, Roth has run or helped manage share sales for China Green Agriculture, Harbin Electric, China Natural Gas, China-Biotics, Wonder Auto Technology, and Orient Paper, all targets of questions and allegations about some combination of mismatching Chinese and U.S. filings or inflated claims in U.S. filings, overpayments for acquisitions, and choosing small auditors. No regulatory action related to these companies has been announced.

Byron Roth, the company's chairman and CEO, says that as the short attacks continued, "everybody had that little moment of, 'Am I the sucker, or are they just full of it?'" Roth adds that there are doubtless cases of fraud among Chinese companies, but not enough of them to outweigh the

investment opportunity. "There aren't that many companies in the U.S. growing at 20 percent-plus," Roth says. "You can't paint every Chinese company with the same brush." He also notes that, as Roth Capital's due diligence procedures "evolve," it checks SAIC filings now, too.

In August 2010, Bird learned through discovery in his suit against MSPC that the SEC was investigating Sky One. Bird promptly posted it to a Yahoo! chat room hosting conversations about Sky One, though MSPC would later get a court order making the discovery documents confidential. In August, Sky One revealed in its second-quarter report that the SEC had launched a formal investigation of its accounting.

Momentum appeared to be gathering. A July 12 audit alert from the PCAOB noted that some U.S. accountants were issuing opinions for companies without visiting China or reviewing the audit work done by local assistants. The examples cited were all companies based in China, Hong Kong, and Taiwan. In the 27 months ended Mar. 31, 2010, the report said, at least 40 U.S. accounting firms with fewer than five partners and fewer than 10 professional staffers had issued audit reports for Chinese companies. "If you're investing in a company whose operations are all in the China region, you may want to ask some questions about the quality of its audit," says Greg Scates, PCAOB deputy chief auditor.

The board has stepped up investigations and inquiries into audits of U.S.-listed Chinese companies since the alert and is coordinating with the SEC, according to its director of enforcement and investigations, Claudius B. Modesti. "Our inspectors continue to raise concerns in our inspections of certain U.S. audit firms regarding their audits of issuers either located in China or that have operations in China," he says.

Throughout the spring and summer of 2010, Bird added to his bet against Sky One and built positions against Orient Paper, China-Biotics, China Marine Foods, China Natural Gas, and China MediaExpress Holdings.

In September, Sky One lowered its 2010 revenue forecast from $160 million to $164 million to between $128 million and $136 million, citing the loss of major distributors. The distributors, Sky One said in a Sept. 3 statement, didn't want their business information disclosed in public SEC filings, which had led to increased scrutiny by the Chinese government. Its shares slumped 31 percent on the first trading day after the announcement. John Bird found himself with a profit of more than $1 million.

Soon, other bets would begin to pay off. In November, Muddy Waters issued a report on Rino International, which Bird was not shorting, accusing the maker of pollution-control equipment of fabricating some of its customer relationships and overstating its 2009 revenue by 17 times, based on SAIC filings. Days later, Rino admitted that some of its contracts did not, in fact, exist. Its shares plunged 85 percent in 2010.

69%

2010 drop in Sky One's stock price

Investors also dumped shares of companies that used Rino auditor Frazer Frost, including Harbin Electric, which Bird had shorted. Harbin dropped 15 percent in two days after trading in Rino shares was halted.

2

Number of partners in the E-Fang Accountancy

A couple of days later, governance research firm Audit Integrity, which rates almost 20,000 public companies, warned U.S. investors about Chinese stocks listed in the U.S. Its system for scoring companies on 100 different accounting and governance metrics had been turning up poor ratings, often a sign that companies are manipulating their numbers, says Audit Integrity's chairman, James A. Kaplan. "I noticed this issue well over a year ago," he says. "But in all candor, no one cared because of the brand of China. China was flying high. If it was branded as a Chinese company, it must mean it was going to be good and make money."

"As these companies are scrutinized, investors will uncover the facts behind the 'Chinese Curtain,'" Kaplan wrote in a Dec. 3 report. "Many of these stocks may prove to be valueless."

Still, there are believers. Bill Wells of Memphis-based Pope Asset Management, a major investor in Sky One and other reverse merger companies, says the China investment thesis still holds. "We see China, and correctly so for the last few years, as the major country with the largest amount of growth," says Wells, whose firm manages about $650 million. It started buying reverse merger Chinese companies in 2005 after large-cap Chinese stocks got expensive. "If you can work through these corporate governance issues, the valuations and the earnings growth on a lot of these companies look pretty attractive," he says. According to SEC filings, Pope Asset held 1,040,224 shares in Sky One as of June 30, 2010. As of the end of September, the fund owned 723,647 shares.

Jeff Papp, a senior analyst for the $300 million Oberweis China Opportunities Fund, which has less than 5 percent invested in reverse merger stocks, is also cautiously positive. "Right now, the whole group is trading at levels implying that they are all frauds, but those who can tell the difference will hit some home runs," he says. "We're either never going to see any of these types of Chinese companies listing here again, or we may be near a bottom in terms of valuations."

Bird did not vacation in New Zealand this past Christmas. Instead he was serenaded by the sound of waves while in a Hawaii beach rental, and he heard only good news from his short-selling experiments. Sky One's shares retreated 69 percent in 2010, and Bird put $500,000 of his $1 million-plus in profits into a startup involved in cancer drug research. His suit against Sky One's auditors drags on. Bird is still short 175,000 shares of the Chinese company and hopes the next salvo will come from the SEC. The commission did not respond to two requests for comment on this story. The SEC's Ma declined to comment.

"The story is not that murky at all. Sky One is a fraudulent company, and all the ticks on the dog are trying to make as much money as they can," says Bird. "When you know the stock is going broke, they're crooks, the SEC is going after them—where are you going to find a better short than that?" What Bird's not so clear on is why other investors don't see things the way he does, saying: "It's unbelievable how the sucker born every minute keeps on wanting to line up and throw their money at these 'opportunities of a lifetime.'" B



worldmags



Home Depot's Fix-It Lady

Chief Financial Officer Carol Tomé has a shot at CEO, if she can solve the retailer's technology problems

By Chris Burritt
Illustration by Ben Kirchner

Carol B. Tomé, the chief financial officer at Home Depot and a leading contender to be the retailer's next chief executive, has caught the technology bug. "I can't wait until the day when I have my credit card loaded up on my smartphone, and I don't even have to carry my wallet—just walk around with my phone," she says, gesturing toward the orange-and-beige Store No. 121, visible from her 22nd-floor conference room in Atlanta. "It's tap and go. It's going to happen. It's all ages, all generations."

It is September, and Home Depot is weeks away from unveiling a mobile app allowing consumers to order merchandise via their iPhone or iPad. "We're already there," Tomé says, visibly pleased that the home-improvement chain would beat its smaller but faster-growing rival, Lowe's, in the race to introduce such a feature.

Lowe's still hasn't introduced its iPhone app, yet Home Depot's small victory is misleading. The world's largest retailer of potting soil and two-by-fours has actually lagged in technology. Until last year, employees stocked shelves as they had for 15 years, using computers powered by motorboat batteries and rolled around stores on bulky carts. The retailer still doesn't offer customers the option to order online and pick up merchandise in stores, as Lowe's does.

Technology was an afterthought as Home Depot for years emphasized opening new stores. When Frank Blake replaced Robert Nardelli as CEO in 2007, he shifted focus to increasing profits from existing outlets. "Inventory turns"—a measure of how well a retailer turns goods into sales—have risen for three straight quarters. Now, Tomé, 54, has the challenging assignment of leading a belated tech catch-up.

Above all, the company must attract younger consumers accustomed to shopping online, often with devices they carry in a pocket or handbag. During the company's fiscal 2010, which ends Jan. 30, Tomé oversaw tech spending of $350 million, or a third of all capital expenditures. Several former top Home Depot executives say Tomé would be the logical internal choice to succeed Blake, 61, when he retires. Her chances of becoming the fifth CEO in Home Depot's 33-year existence may depend on whether she succeeds at improving the chain's in-store technology as well as boosting online transactions, which amounted to less than $1 billion, or 1.5 percent of its estimated 2010 sales of $68 billion. "The way people shop in the future—Carol is going to craft that for Home Depot," says Carl Liebert III, who left as executive vice-president for stores in 2006 to become CEO of 24 Hour Fitness Worldwide. "It certainly puts her in the driver's seat for replacing Frank when that time comes."

Home Depot's tech troubles provide some sobering lessons for other brick-and-mortar retailers as they try to capture mobile-device sales. When processing special orders for customers, Home Depot employees are now forced to use "prehistoric" technology, hurting both service and sales, Marvin Ellison, the company's executive vice-president for U.S. stores, said at a Goldman Sachs conference in New York in September. Home Depot also needs to improve its website to lure the 7 in 10 customers who first browse online, Blake said at the conference.

For more than a decade, the company neglected the tech revolution, preferring to open stores—more than 100 a year through 2005. Today there are 2,244 in all. Tomé was in the thick of the real estate binge. She still heads the corporate committee that oversaw that expansion, though in 2008 it became clear that demand for big-box home-improvement stores had reached the saturation point. Now it is up to her to approve the big-ticket tech spending needed to move Home Depot online.

In 15 years at the company, Tomé is the only senior executive to work for all four of its CEOs. She has advanced, colleagues say, by combining sharp intelligence with a zeal to learn the business from the hammers and nails on up. Stepping off the elevator at Atlanta headquarters one morning, she is dressed in black with a pearl bracelet on her right wrist and fashionable glasses with black-and-burgundy frames, one of more than a dozen pairs she owns. She carries an ostrich-skin tote bag. A coat rack in her office bears more than 90 orange aprons decorated by employees of stores she has visited. Tomé tours at least one outlet a week, talking to customers and quizzing workers. "Carol can mix paint," says Cara Kinzey, a senior vice-president for information technology, recalling a particularly detailed grilling by the CFO over the 2009 purchase of new paint-blending equipment and other improvements. "We always have to pay for these projects with results."

The oldest of four children, Tomé first learned about finance in Jackson, Wyo., where her father ran the family-owned Jackson

Modernizing the Big Box
Under Tomé's leadership in 2010, Home Depot invested in 40,000 handheld devices made by Motorola. The "First Phone" allows Home Depot associates to manage inventory and help customers find the right screws.



Tomé, in a Home Depot store in Atlanta, tours at least one outlet every week


ERIK S. LESSER/BLOOMBERG

"We were...like that Kevin Costner movie: Build a store, and they will come. That's no longer the case. We need to look at what we're doing inside the company to grow"

State Bank. She assumed that one day she would become Jackson State's first female CEO. When she was studying for an MBA at the University of Denver, however, her father called with news that upset her plans: He was divorcing her mother after 27 years of marriage and selling Jackson State.

"When I calmed down, I said to myself, 'Carol, you are going to be a banker. So be a banker,'" Tomé recalls. "As I sit here today, the best thing that ever happened to me, personally and professionally, was the fact that he sold the bank." Setting off on her own, she joined United Bank of Denver, and that led to a series of corporate finance jobs that landed her at Home Depot in 1995.

In 2000, Home Depot hired a new CEO: Nardelli, a cost-cutter who had been a runner-up in the contest to succeed Jack Welch as General Electric's CEO. Nardelli had a rocky time in the home-improvement business. During his tenure, customer satisfaction slipped and sales growth trailed that of Lowe's. His compensation of $225 million over six years also provoked grumbling. For Tomé, though, the Nardelli era proved fruitful. He promoted her from treasurer to CFO in 2001; when other executives left, her responsibilities expanded to include store operations and customer service. The board ousted Nardelli in 2007, but Tomé's status did not suffer. She was paid $5.2 million last year. Nardelli, now head of the operations and advisory unit of New York-based buyout firm Cerberus Capital Management, declined to comment.

"I've never run into [a CFO] who knew the business as well as Carol does," says Virginia A. Hepner, Wachovia's senior banker for Home Depot during Tomé's first seven years at the retailer. (Wachovia is now part of Wells Fargo.) "At work, she is all business, always focused, calm, and professional," says Hepner. She and Tomé and their husbands share interests in the arts, gardening, and cooking. "Carol makes a wicked chocolate mousse," Hepner says. They socialize at the Tomés' Italian Renaissance-style home in the Atlanta suburb of Buckhead. Tomé's husband, Ramon, is a chemist with the Georgia Natural Resources Dept.

The Home Depot executive, who has rounded out her résumé by serving as a director of United Parcel Service and chairman of the Federal Reserve Bank of Atlanta, won't comment on whether she wants to run the retailer. She notes, though, that she demurred when a headhunter called last year about a possible lateral move to Bank of America. "I've got the best CFO job in the country, so why would I want to entertain another CFO position?" she says. Her boss, Blake, who doesn't face mandatory retirement as CEO, won't talk about succession, saying, "I want to avoid horse race discussions."

Getting Home Depot up to speed on technology became a key test for Tomé last March, when she and Blake attended an off-site on the company's mobility future. Executives heard presentations from vendors of video cameras tied to computers that guess shoppers' ages and suggest purchases on their smartphones, mobile devices for contractors to order work-site deliveries, and other gadgets. With so many possibilities, Blake asked Tomé to come up with a plan. The result was Home Depot's mobility committee. "The assignment for Carol was very logical," Blake says. "She has the breadth of view to coordinate that. She's a very bright woman with a good sense of the business."

Under her leadership in 2010 the company laid out $60 million to buy 40,000 handheld devices to replace the in-store computers from the early 1990s. In October it launched a blogging site at homedepot.com where employees answer customer questions on such matters as repairing a door damaged by direct sunlight. "Clean tools are happy tools," wrote a store expert who uses the handle TheHammer. He recommended glass cleaner to remove grease from pliers. As part of a broader upgrade of checkout systems, the company's U.S. stores have lately installed contact-less scanners for reading credit-card information on smartphones. They're not in use yet, says Dwaine Kimmet, treasurer and vice-president for financial services. "We did it for the future, to keep our options open."

Tomé's tech challenge will be complicated by the preference of most older contractors and do-it-yourselfers to buy in person at a store. "You have to serve customers the way they want to be served," Blake says. Tomé reinforces this point, stressing that the company's largest category of capital spending remains maintenance of stores, including bathrooms. "It's very much defensive spending," she says.

Colin McGranahan, an analyst at Sanford C. Bernstein, says Tomé is headed in the right direction. "Over the long run, consumers are going to be a lot more comfortable using their smartphones on a real-time basis researching outside or inside the store." He rates Home Depot as "market perform," a prediction that its results will be similar to that of the overall market.

In 2009 the square footage of Home Depot stores declined by 1.3 percent, the retailer's first annual drop ever, and it was essentially unchanged in 2010. "We were very much like that Kevin Costner movie: Build a store, and they will come," Tomé explains. "That's no longer the case. We need to look at what we're doing inside the company to grow. Our economic engine will be driven by productivity and efficiency." B

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worldmags

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You can't judge a woman by her bag ... can you? Page 76



The Robot Revolution Is Coming

The office of tomorrow is likely to include workers that are faster, smarter, more responsible—and happen to be robots. *By Eric Spitznagel*

Photograph by Fredrik Broden

TOP: PATRICKMCMULLAN.COM

worldmags

Etc. The Office Robots

Between the global economic downturn and stubborn unemployment, the last few years have not been kind to the workforce. Now a new menace looms. At just five feet tall and 86 pounds, the HRP-4 may be the office grunt of tomorrow. The humanoid robot, developed by Tokyo-based Kawada Industries and Japan's National Institute of Advanced Industrial Sciences and Technology, is programmed to deliver mail, pour coffee, and recognize its co-workers' faces. On Jan. 28, Kawada will begin selling it to research institutions and universities around the world for about $350,000. While that price may seem steep, consider that the HRP-4 doesn't goof around on Facebook, spend hours tweaking its fantasy football roster, or require a lunch break. Noriyuki Kanehira, the robotic systems manager at Kawada, believes the HRP-4 could easily take on a "secretarial role ... in the near future." Sooner or later, he says, "humanoid robots can move [into] the office field."

Robotic workers aren't completely new. General Motors employed one on an assembly line in 1961, and—according to *World Robotics*, an annual report produced by the Frankfurt-based International Federation of Robotics—there are currently 8.6 million robots in use around the world. Many of them have been doing jobs that humans can't do in places humans can't go, such as plugging oil leaks in the Gulf of Mexico. As a result of breakthroughs in technology, however, a new breed of machines may soon be filing papers and pushing the mail cart. In a 2007 issue of *Scientific American*, Bill Gates predicted that the future would bring a "robot in every home." In the foreseeable future, though, it may be a robot in every cubicle—or at least every third cubicle.

Industrial and technological companies across the globe are already hard at work trying to make this a reality. The QB, a "remote presence robot" created by Anybots, based in Mountain View, Calif., is basically a videoconferencing system on wheels. The QB, which looks a little like Wall-E, is controlled remotely through a Web browser and keyboard, allowing managers to virtually visit satellite branches from the comfort of their offices. The $15,000 QB was unveiled in May, and according to Anybots' founder, Trevor Blackwell, sales are in the hundreds. "Everyone already has videoconferencing," says Blackwell. "Yet planes are still full of people traveling for business. We're trying to find a way to solve that problem."

For around the same price, Smart Robots, based in Dalton, Mass., offers a more ambitious office robot called the SR4. Models range from an $7,495 SR4 Professional to the $18,950 SR4 Office, which resembles R2-D2 with a clear glass top. Joe Bosworth, Smart Robots' chief executive officer, says the SR4 is just as smart as C-3PO's little buddy. "I would describe it as a gofer," he says. "A point-to-point robot should be able to go from any desk to any desk within a multistory office. It should be able to take mail down to the mailroom and then travel across the street to pick up a latte." Bosworth, who has been involved with Smart Robots since 2002, anticipates criticism from those claiming the SR4 is just a fancy way of replacing human employees. "Are there humanoids—sorry, *humans*—who do these kinds of things in larger offices? Absolutely," Bosworth concedes. "Is this intended to displace them entirely? Not really. But does it in fact save some labor in certain circumstances? Yes."

A new wave of office robots can file papers and fetch lattes from Starbucks

For businesses with deeper pockets, there's the PR2, a "personal robot" developed by Willow Garage, a robotics research group in Menlo Park, Calif., founded by Scott Hassan, one of the original architects of the Google search engine. PR2 officially hit the market last September for $400,000, and Samsung became one of its first customers. Unlike more affordable office robots, the five-foot-tall, two-armed, rolling PR2 can do remedial problem solving, open doors without instruction, and plug itself into a wall socket when its battery is running low. And as seen in Garage's video demonstrations, it can fetch a beer from the fridge and play a mean game of pool. Soon enough, people won't even need real friends.

When it comes to trepidation about robots entering the workplace, Tim Smith, a spokesperson for Willow Garage, takes a historical approach. "People always seem to fear new technology," he says. "I suspect Ben Franklin got a lot of grief when he started the post office and suddenly the government knew where everybody lived." Like them or not, Willow Garage is betting that once robots enter the workforce, com-

A Buyer's Guide to Office Bots

Looking to make an informed and responsible robot-buying decision? Here are



	HRP-4
Cost	$350,000
Country of Origin	Japan
Human-Resemblance Quotient	It's designed "in the image of a lean but well-muscled track-and-field athlete," says Kawada Industries Manager Noriyuki Kanehira
Mobility	Can stand on one foot, twist its waist, and strike poses
Interaction Ability	The head contains sensors for face recognition and tracking. So it's like those creepy paintings where the eyes seem to follow you
Cognitive Ability	None. "To be productive, the robot has to have imagination," says Kanehira. Unfortunately, this robot has no imagination
Creepy-Robot Factor	Using VocaListener technology, it can mimic human sounds like singing and heavy breathing. Finally, a bot capable of pervy phone calls

panies won't ignore the technology. "When you add a mobile-manipulation robot like the PR2, things get really exciting," says Joshua Smith, an associate professor of science and engineering at the University of Washington in Seattle. "A robot makes it possible for software to move objects around and change the physical state of the building." Notes Willow Garage's Smith: "If the U.S. wants a hand in this market, now isn't the time for restrictions on robots based on silly, ungrounded fears."

Hyoun Park, an analyst at the Boston-based technology research firm Aberdeen Group, agrees that there's nothing to fear from robots but fear itself. "The current state of robotics is less suited to replacing employees in a downturn," he claims, "and more suited to the cliché of doing more with less." Not everyone believes the coming nuts-and-bolts workforce is completely benign. Entrepreneur Marshall Brain—that's his real name—says robots will become widely available by 2030 and could eventually take nearly half of all jobs in the U.S. "We've been very busy creating the second intelligent species," he says.

"We've been very busy creating the second intelligent species"

Brain, who sold his website HowStuffWorks to the Discovery Channel for $250 million in 2007, suggests that robots are a threat to employees at all levels on the corporate totem pole. Even higher-level thinking—the very quality that many managers say separates them from their staff and from artificial intelligence—can be broken down into easily replicated formulas. "Management is one area where a dispassionate robot that's able to disperse tasks and evaluate employee performance in a perfectly rational way might do a better job than a human," he says.

The office robot is closing in on upper management-level skills with surprising speed. At Georgia Tech, research engineer Alan Wagner has been collaborating with professor Ronald Arkin on cracking the code of robot intelligence. According to Wagner, their research aims "to build robots that can not only interact with humans but are also capable of representing, reasoning, and developing relationships with others." They developed an algorithm that, they claim, allows robots, just like CEOs, "to look at a situation and determine whether [it] requires deception, providing false information, to benefit itself." Basically, they taught robots how to lie.

This potential for duplicity may be even more alarming to human employees who might one day lose their jobs to a gang of Wall-E doppelgängers. Yet Smart Robots' Bosworth insists that the rise of ever-more sophisticated robots offers a sliver of hope to minions everywhere. "Technology makes jobs, it doesn't do away with jobs," he says. Bosworth points to the invention of the television, which created a new industry in television repair. He predicts that there's a fortune to be made in preventive robot maintenance. This isn't the best news for those with bigger career ambitions than being grease monkeys for robots. Though in a market where robots may be taking all the good jobs, work is work, right? Ⓑ

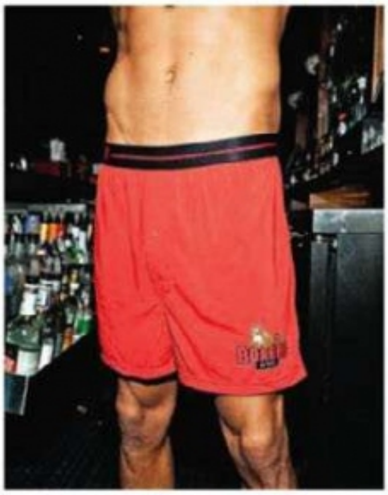
some options for assisting (or replacing) your employees:





PR2	ANYBOTS QB
$400,000	$15,000
U.S.	U.S.
Despite having two arms, it looks like a telescope-vacuum cleaner hybrid	It looks vaguely like Wall-E, the robot imp from the 2008 Pixar film
In a December test, the PR2 traveled 86 miles around an office without stopping. The process took almost two weeks	Runs on Segway-style wheels
During its "graduation party" last May, the PR2 demonstrated a talent for dancing with humans	The QB has a video camera for eyes—"not quite as good as your"—that is, human—"eyes," concedes Anybots founder Trevor Blackwell
Smart enough to fetch a beer from the fridge with the use of a "Beer Me" Web app	Since it's essentially a roaming videoconference center, it's your brain in a robot's body
Maker Willow Garage has a "Safety Board" to prevent the robot from hurting humans—which sounds a little Orwellian for the office	A laser pointer in its right eye, designed for pointing at things in the office, looks like an ominous death ray from a Bond movie

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Boxers NYC has strict uniform requirements for its bartenders



The New Boys' Club

Gay sports bars are popping up throughout the U.S.—and they're making a killing. *By Kurt Soller*

From the outside, Boxers NYC looks like the kind of sports bar you might find in a suburban strip mall. Large windows reveal 14 flat-screen TVs, two pool tables, and a dartboard. Inside, men in suits sit atop vinyl-covered stools, fidget with their BlackBerrys, and swill pints of beer—served by bartenders dressed in their underwear. After all, Boxers wasn't named for the sweet science, but for the style of skivvies its clients prefer.

Less than a year after opening in Manhattan's Flatiron district, Boxers has become a pioneer of the gay sports bar movement. Equal parts generic pub and gay boîte, it has Lady Gaga on its speakers and Knicks games on its TVs. "The sports theme allows people to be comfortable," says Bob Fluet, a co-owner who met his business partner, Rob Hynds, in a gay softball league. The two realized that while the gay community had plenty of nightlife options, it lacked an old-fashioned watering hole where guys could root for the home team. "I don't want to go to some fancy lounge and drink martinis," says Hynds. "Or end up at a leather bar." So far it's working: Since Boxers opened in April 2010, Hynds says, sales are tracking 45 percent above their initial forecast.

"A place where you can cheer on your team and talk about how hot they look"

In the past few years, nearly a dozen sports bars catering to a gay clientele have opened around the country, including Crew in Chicago, Fritz in Boston, GYM Sportsbar in Los Angeles, Score Bar in Columbus, Ohio, and Woof's in Madison, Wis.—which bears no official relation to Woofs in Atlanta. The sudden success has even surprised some proprietors. "Quite frankly, we had no idea that gay men and women really loved sports," says Jennifer Morales, the marketing director of SideLines sports bar, outside

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Fort Lauderdale, which recently reopened after a $20,000 renovation.

The bars are profiting from a rare demographic group with a growing amount of disposable income. Market research firm Witeck-Combs Communications puts the buying power of the adult lesbian-gay-bisexual-transgender (LGBT) population at $743 billion, up from $732 billion in 2009. With large populations in metropolitan areas and more households without children, gay sports fans are actually the perfect customers to catch a game on a Wednesday night.

The trailblazer, Nellie's Sports Bar, opened on U Street in Washington, D.C., in 2007. It was designed specifically to appeal to both hard-core sports fans and clubland loyalists, and the decor features a mix of team pennants and pictures of Abercrombie & Fitch models. Traffic has increased 30 percent each year, says owner Douglas Warren Schantz. "I'm not even a sports fan; I just have a lot of experience in marketing and advertising," says Schantz of his previous career at Ogilvy & Mather. "You can't just open a stereotypical gay bar and expect that one set of people. That group's already been targeted."

Schantz intentionally inserted the words "sports bar" in his establishment's name to aid neighborhood Internet searches–and to attract potentially fearsome heterosexuals. While Nellie's brims at night with a crowd of strivers who want to drink vodka sodas before heading to Town–a popular gay Washington dance club–it plays host to neighborhood fans during the afternoon. Schantz expects to pay back his sixth, and final, investor by next year.

The key for each bar has been striking the right balance to appeal to both gay and straight fans. "Since we're a gay bar, people call asking about karaoke, live bands, and drag," explains Morales of SideLines. "I just scream, 'No! No! No!' We've filled a niche where we're all about sports." She also insists that SideLines has eschewed another stereotype of gay bars: It has trained its staff to be extra friendly, replacing the haughty attitude some workers may have developed at more glamorous nightclubs. Appealing to one kind of clientele without alienating the other is complicated. "I feel like this is the Olive Garden of gay bars," says Kevin Teague, a 34-year-old architect who recently visited Boxers for an afterwork meeting. "It's a nondescript bar for nondescript gays."

When it comes to food, however, many gay sports bars are, well, pretty gay. At Crew in Chicago, a selection of sliders is referred to as Marvelous Minis, while another sandwich is called the Threesome Grilled Cheese. Adventurous eaters might order their wings with Sassy Sauce, which the menu describes as "just like Friday night's fling–tangy and HOT!!!" At Boxers, a four-cheese pie, "A's Rod," is offered alongside meatier options like the Italian Stallion and The Batter's Box. The bar also offers half-price drinks after 9:30 p.m. on Saturdays to those wearing nothing but their underwear.

"We've filled a niche where we're all about sports," says one bar's marketing director

Winks to gay sexuality are also part of Schantz's marketing plan. Nellie's New Year's Eve entertainment featured a packed schedule of college bowl games–and a drag queen named Shi-Queeta-Lee. Its menu is equally varied, including empanadas, arepas, and edamame in addition to burgers and nachos. "Sports bars don't have a great reputation for food, but we have a really great menu," Schantz says, before adding, "That's so gay. Of course the gay sports bar is gonna be the one with good food!"

While no U.S. city besides New York has more than one such bar, many communities are clamoring for their first. Before GYM Sportsbar opened in Los Angeles, one fan started a Facebook group called "Draft a Gay Sports Bar to LA." His pitch contained the selling point: "This is a group for anyone and everyone who would love to have a gay sports bar in Los Angeles, a place where you can cheer on your team and talk about how hot they look in tight pants." Less than a year after opening Boxers, Fluet and Hynds are scouting for a second location. "There should be a bar like this in every American city," Fluet says. "If someone won't open it quickly enough, we will." The two are very interested in opening a bar in Washington, thus prompting another first: a gay sports bar rivalry. "I'd love to see how much Nellie's is making," says Fluet. "We want to take them on." B

The Gay Sports Bar Pioneers

In the past few years, nearly a dozen thriving gay sports bars have emerged. Their formula? Adhering to the staples of pub–and gay club–culture.



Boxers NYC, New York

Sports bar touch:
Saturday night beer pong tournaments
Gay bar touch:
After those tournaments, drinks are half-price for guests who leave their jeans at the "free pants check"



Nellie's Sports Bar, Washington, D.C.

Sports bar touch:
Monday poker nights and 25 televisions
Gay bar touch:
Tuesday is "drag bingo" night, and all the TVs are tuned to *Glee*



Crew, Chicago

Sports bar touch:
More than 60 beers are available
Gay bar move:
Nine salads are offered with the option of blueberry pomegranate vinaigrette dressing on the side



SideLines Sports Bar, Wilton Manors, Fla.

Sports bar touch:
Texas Hold'em video game and foosball table
Gay bar touch:
Jukebox includes the musical stylings of Lady Gaga and Sade



Roscoe's on 7th, Phoenix

Sports bar touch:
$2 Bloody Mary specials with numerous options of ingredients
Gay bar touch:
A performance every Friday by The American Leathermen Dancers



Fritz, Boston

Sports bar touch:
The establishment supports 10 recreational teams throughout the city
Gay bar touch:
Team names include the Bears (basketball) and the Bare Backs (softball)

OPPOSITE PAGE: PHOTOGRAPHS BY ANDREW HETHERINGTON FOR BLOOMBERG BUSINESSWEEK; THIS PAGE: THOMAS NORTHCUT/GETTY IMAGES; FOX TELEVISION/EVERETT COLLECTION; DOMINO/GETTY IMAGES; KUTAY TANIR/GETTY IMAGES; DENNIS GOTTLIEB/GETTY IMAGES; JUN SATO/WIREIMAGE

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Where the Wild Things Are

Manila-born Cortes noticed mostly Europeans on his yearly African safaris. He saw the potential in persuading Asians to make the trip

Jose Cortes turned a passion for African wildlife into a business adventure. *By Katrina Nicholas*

Unlike many bankers, when Jose Cortes craved blood he wasn't plotting how to poach a deal. Instead, he was watching a lion stalk a buffalo. Beginning in the mid-'90s, the Hong Kong-based JPMorgan Chase investment banker, now 45, visited Africa yearly. On one memorable trip, in 1997, he was transfixed by the sight of 14 lions hunting three buffalo in Botswana—and realized there was a business opportunity in introducing more Asian travelers to African safaris.

In late 2002, Cortes and a friend, Victor Dizon, began laying groundwork for their new business. Working out of their apartments in off hours—Cortes in Hong Kong, Dizon in Manila—the bankers contacted African tourism boards in Asia, negotiated rates with safari lodges, began hiring staff, and pitched colleagues on custom safaris. Cortes took a four-month sabbatical to scout camps and reserves.

A year later Asia to Africa Safaris was launched, but Cortes returned to Hong Kong and the financial-services industry. All the while he was working with Dizon to design more safaris, fielding calls from potential partners, and wooing clients on weekends. From 2003 to 2006, the company went from working with 30 safari camps to more than 120. By late 2006 it was arranging more than 200 trips per year. Clients spend, on average, between $7,000 and $10,000 per 7- to 10-day trip (excluding airfare). Luxurious family safaris can run up to $300,000.

Last spring, Cortes decided to leave corporate life altogether and move his family to Cape Town. "My boss pointed out the next five years would be the best income-generating ones of my life," he says. "But it's not all about money. When you convince someone to go to Africa and they come back saying it was the best trip of their life, that's 100 times better than hearing a CFO say, 'Thanks for doing my deal.'"

The company now has offices in Hong Kong, the Philippines, and Singapore, and a staff of 20. Meanwhile, Cortes remains busy scouting more exotic destinations. "People are after an experience that's exclusive," he says. "It could be mountain gorillas in Rwanda or Uganda. When people compare notes after summer break, a tribal safari in Africa beats Tuscany, hands down." Ⓑ



A Tanzania trip takes clients near a million wildebeest on their annual migration



CORTES ARRIVES IN AFRICA

4,000+ Number of people who have gone on trips designed by Asia to Africa Safaris	**$2,000** What Asia to Africa charges for a night of lodging at a top accommodation, per person
31 Miles covered on a four-day canoe journey along the Zambezi River	**30%** A generous estimate of safari locations with mobile phone coverage

DATA: ASIA TO AFRICA SAFARIS

FROM TOP: PHOTOGRAPH BY PER-ANDERS PETTERSSON FOR BLOOMBERG BUSINESSWEEK; MIKEL BILBAO/AGEFOTOSTOCK AMERICA

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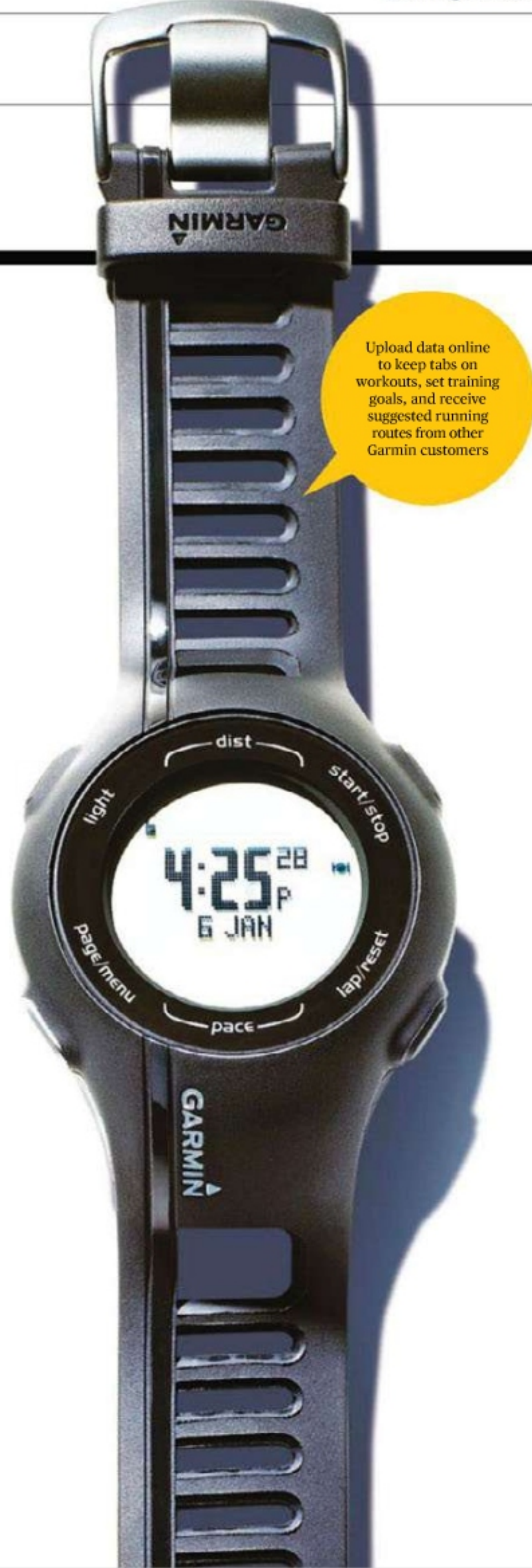
Etc. One True Thing

The Gym Gizmo

The Garmin Forerunner 210 watch will smarten up your lunch hour workout

The Want: A simple fitness accessory that satisfies New Year's resolution gym goers and veteran workout buffs. It should fit in your bag and not make you look like a freak.

The Get: Garmin's Forerunner 210 ($299.99 at garmin.com). The GPS-enabled waterproof watch records real-time pace and distance. It has a shoe pod that tracks distance when you're running in place on a treadmill, and a monitor for recording heart rate. Plug it into the wall to recharge the battery, which lasts about eight hours in training mode. If only you could last that long. Ⓑ —*Jessica Flint*



THE BOD SQUAD

Discreet gym gear that can live in your workout bag



Waterproof MP3 Player

One-up Michael Phelps, who played his iPod *before* races at the Beijing Olympics, by diving in with Finis's XtreaMP3. It holds about 240 songs and has playlist and shuffle functions. *$149.99 at finisinc.com*



Calorie-Counting Jump Rope

The foam handles on Grizzly Fitness' LCD Digital Rope display time, weight, and calories burned. The rope, which can be adjusted to your height, also counts the number of jumps. ***$29.95 at grizzlyfitness.com***



Massage Stick

After a run, roll the beaded plastic Marathon Stick over your various muscle groups to alleviate soreness. It also helps prevent injuries by compressing and stretching your muscles. *$31.95 at thestick.com*



Cycling Gloves

Imitate a professional racer by wearing Rapha's Pro Team Mitts to spinning class. The gloves even include a suede nose wipe. Soon enough you'll be donning a silk cycling scarf. *$80 at rapha.cc*

WATCH: PHOTOGRAPH BY JAMIE CHUNG FOR BLOOMBERG BUSINESSWEEK

Etc. The Office Lab

Your Handbag, Your Self

Your purse is talking about you. Here's what it's saying. *By Meredith Stebbins*

To assess a lady's character, look no further than the handbag she carries to work. "It is an absolute indicator of who they are and what their style is," says Rachel Zoe, celebrity stylist and entrepreneur. Since a purse's size and shape isn't limiting like a pair of skinny jeans, a bag is an easy way for a woman to express herself—especially in the workplace. "For the majority of women, the handbag is the most important part of the outfit because it doesn't have to do with your body type," says Kate Schelter, a New York-based stylist and brand consultant. Perhaps that's why the global luxury handbag and accessories market is about $24 billion, according to Coach CEO Lew Frankfort.

Whether it's an oversize carryall or structured satchel, a bag's details—right down to the buckle—reveal clues about its owner. Not to mention that "how you wear the bag is just as important as the bag itself," adds Schelter. Slinging it across your body sends a different signal than nestling it on the crux of your arm. Having your assistant tote it for you says something, too.

In order to decode the language of work-bag-speak, *Bloomberg Businessweek* called on a panel of fashion experts, including Zoe; Schelter; International Best-Dressed List Hall of Fame honoree Amy Fine Collins; and handbag designer Rebecca Minkoff. Next time you're in the elevator, think twice about rifling around that mammoth hobo for your ID badge: You're giving off a disorganized vibe. **B**

Fig. 1

The Eternal Prepster





A woman who totes Longchamp's classic Le Pliage canvas bag to the office is conservative and traditional, yet secretly relishes carrying a status symbol. "She is wearing plaids and pearls," says Zoe. Adds Minkoff, the owner is "practical and loves a bag where she can carry all her essentials at once." *$135*

Fig. 4

The Multitasker





A young gal who wears many hats in addition to her 9-to-5 job favors an expandable bag with many pockets. "She was voted Most Likely to Succeed in high school," Collins says. "She's a little bit safe in her dress, but in a cute way." The purpose of her tote "is to allow her to be hands-free," says Minkoff. *$595*

Fig. 7

The Pantsuit Executive





A leather handbag from a luxury house such as Mulberry completes the no-nonsense executive's professional look. "With the power women of today, they want to be taken seriously," Zoe says. "They also want to look fashion-forward." Schelter: "It is very easy to put files and a laptop in here." *$1,150*

Fig. 8

The Party Girl





A crossbody bag that doubles as a clutch screams "work hard, play harder." The owner is "still young enough to go out at night after work," says Schelter. "This has the long chain for when you need two hands free for drinking," Collins notes, saying the wearer "might not be coming home at all." *$295*

BAGS: PHOTOGRAPHS BY DAVIES AND STARR FOR BLOOMBERG BUSINESSWEEK; ILLUSTRATIONS BY WALTER NEWTON; 1. LONGCHAMP LE PLIAGE, LONGCHAMP.COM 2. FEED 1, FEEDPROJECTS.COM 3. LOUIS VUITTON ALMA, LOUISVUITTON.COM

Fig. 2

The Upwardly Mobile Do-Gooder





The legions of young urbanites who cart around burlap bags designed by FEED, a philanthropic organization whose mission is to curb global hunger, are "obviously concerned about the world and the environment," says Zoe. She's "a little crunchy but brand-aware," adds Collins. *$60*

Fig. 3

The Lady Who Luxes





A ladylike Louis Vuitton bag is the standard arm candy of a woman who has feminine—and expensive—taste. "This woman is a label freak," Collins says. Adds Zoe: "She has a job, but she may not need the money." Minkoff notes: "You'll never find her outside her house without the 'It' heels." *$1,030*

Fig. 5

The Brooklyner





A vibrant print bag is the sign of a city-dwelling hipster who doesn't care about dress codes. "She isn't too worried about her bag matching her shoes matching her belt matching her outfit," says Zoe. "It's for the style blogger," says Schelter. Collins adds: "She doesn't get her hair blown straight." *$258*

Fig. 6

The Power Mom





The leather shopper was made for working moms. She "needs room to keep all her necessities in place while running around in between meetings and playdates," says Minkoff. Its wearer likes labels, says Collins, "but doesn't need to show them." Schelter adds that its price makes it "still a treat." *$295*

Fig. 9

The Early Adopter





A purse designed by an of-the-moment fashion darling suggests the wearer isn't referring to real machinery when talking about hardware. "This bag doesn't have a lot of functionality," says Zoe. "You make it work because you love it." Adds Collins: "People think she's on the cutting edge." *$825*

Fig. 10

The Hoarder





Massive oversized bags show "that maybe you're not as focused as you need to be because you can't edit what's in your handbag," says Schelter. "If you go to a job interview with a bag the size of your body filled with crap, they're going to be a little nervous," says Zoe. Collins agrees: "She is kind of a mess." *$395*

4. MARC JACOBS CAMMIE CLASSIC LARGE LEATHER CROSSBODY BAG, BLOOMINGDALES.COM 5. PENDLETON BUCKLE BAG, URBANOUTFITTERS.COM 6. DKNY FRENCH GRAIN LEATHER WORK TOTE, DKNY.COM 7. MULBERRY BAYSWATER, MULBERRY.COM 8. REBECCA MINKOFF MORNING AFTER CLUTCH, REBECCAMINKOFF.COM 9. ALEXANDER WANG DIEGO BUCKET BAG, SHOPBOP.COM 10. CYNTHIA VINCENT BOSTON LARGE SHOULDER BAG, SHOP.CYNTHIAVINCENT.NET



The Reagan-Era Nip-Tucks

Is the U.S.'s fixation on plastic surgery the result of Reaganomics? *By June Thomas*

Among the reasons commonly cited for plastic surgery, trickle-down economics is rarely invoked. Yet the market forces unleashed by Ronald Reagan's laissez-faire policies may have helped set in motion one of the U.S.'s favorite avenues of upward mobility. In 2009, Americans spent about $10.5 billion on plastic surgery, according to the American Society for Aesthetic Plastic Surgery. That's about 20 percent less than they paid in 2007—a drop that can be attributed to the recession and Botox's migration down the price ladder from the doctor's office to the spa. And that's about as much money as governments and institutions pledged to the victims of the 2010 Haitian earthquake. At least we have our priorities straight.

While the root causes of this fixation may range from Pamela Anderson's bosom to Joan Rivers' cheeks, Middlebury College sociologist and author Laurie Essig starts with the Gipper's Economic Recovery Tax Act of 1981. "When more money was given to the rich," Essig writes in *American Plastic*, "they got richer, while average Americans were left with fewer and fewer social services and a labor movement that was consistently and purposefully opposed by the federal government." The result, Essig claims, was that many Americans assumed more debt, and suffered for it.

In 1982 a Supreme Court ruling allowed members of the American Medical Assn. to advertise their services—an opportunity that few cosmetic surgeons wasted. These promotions, Essig suggests, transformed many Americans' view of elective surgery from that of "a medical relationship between a surgeon and a patient to a commercial relationship between a consumer and a service provider."

Many also began to view surgery as a solution to their economic woes. Essig argues that America's love affair with liposuction, long considered a late-life pastime of the rich, was actually formed from long-term financial insecurity compounded by easier access to credit. By the 1990s, she suggests, the deregulation of the Clinton years permitted banks to extend credit to a wider population, and lower-in-

i

American Plastic: Boob Jobs, Credit Cards, and Our Quest for Perfection

By Laurie Essig
BEACON
219 pp, $26.95



ILLUSTRATION BY LIE-INS AND TIGERS

come women came to see breast implants and tummy tucks as a sensible career-enhancement strategy—albeit at the risk of their future financial health. Subsequently, plastic surgery silently descended the social hierarchy from the lives once portrayed on *Dallas* to those on the now-defunct reality show, *The Swan*. According to a 2005 poll conducted by the American Society of Plastic Surgeons, 30 percent of plastic surgery patients earned less than $30,000 a year, while an additional 41 percent earned between $30,000 and $60,000. And many of their procedures, she notes, were financed with high-interest loans.

Splurging on a tummy tuck might actually be a sensible survival instinct. As Essig says, "Working-class bodies, which tend to be larger and have less access to things like braces for straight teeth or dermatologists for smooth skin, also elicit more disgust than the smooth, pampered bodies of the upper classes." Passing for rich is yet another bulwark against downward mobility, she notes, and sometimes that requires physical transformation.

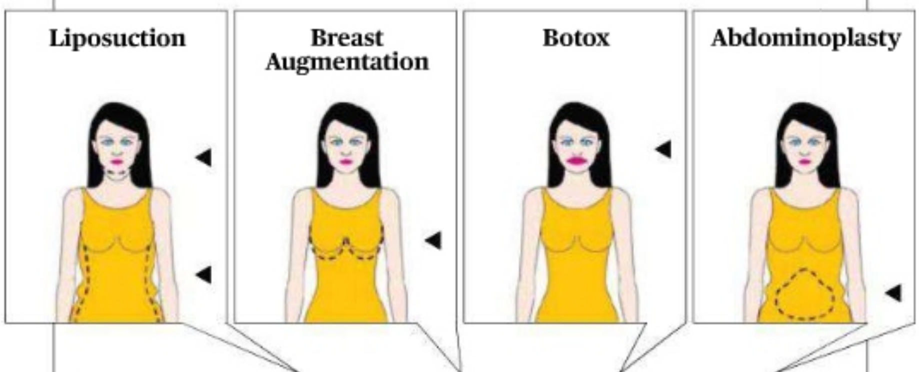
Essig backs up these sweeping assertions with some provocative examples. Nearly all of the 140 potential patients she spoke with claimed they were planning to go under the knife as a response to economic insecurity. Some were afraid of losing their jobs; others felt they needed to disguise their age to secure a new position. Rita, a fiftysomething woman in the hospitality industry, told Essig that in today's workplace, "it's about how you look, not what you do. I do believe that nine times out of 10, women with the hot bodies get the best jobs." Essig also argues that women who sign up for face-lifts hoping to hold on to their husbands are acting out of a rational financial interest in avoiding divorce.

For many Americans, though, surgery obviously isn't the most sensible investment. Many would almost certainly get more bang for their buck by taking a class or eating better. As individuals have had to shoulder more responsibility for their own financial security—and as well-worn paths to prosperity have become less reliable, with markets and retirement accounts only now recovering—perhaps it isn't surprising that people have turned to more drastic options.

Some unabashed fans of capitalism may admire the cosmetic surgery industry's ability to broaden its clientele in leaner times—particularly since the future for the makeover trade looks even brighter. As Americans live longer, they'll continue to head to the doctor's office, which, Essig writes, many patients see as "an excellent solution to the crisis caused by an aging yet still youth-obsessed generation." In retrospect, perhaps that's how Reagan saw it, too. B

Pieces of Work

Boob jobs, lipo, and tummy tucks aren't limited to Hollywood starlets and Manhattan housewives—or even bull markets. According to the 2009 data from the American Society of Plastic Surgeons, Botox provides the change that any American can believe in



	Liposuction	Breast Augmentation	Botox	Abdominoplasty
New England and Middle Atlantic	33,537	41,420	961,788	22,265
South Atlantic	43,131	45,166	1,122,869	20,302
East South Central and West South Central	28,907	47,614	696,714	19,105
East North Central and West North Central	25,759	47,476	672,710	21,145
Mountain and Pacific	66,917	107,652	1,341,276	32,374
Regional Totals	198,251	289,328	4,795,357	115,191
Grand Total	5,398,127			

REGIONAL BREAKDOWNS: **New England and Middle Atlantic:** CT, ME, MA, NH, RI, VT, NJ, NY, PA **East North Central and West North Central:** IL, IN, MI, OH, WI, IA, KS, MN, MO, NE, ND, SD **South Atlantic:** DE, DC, FL, GA, MD, NC, SC, VA, WV, PR **East South Central and West South Central:** AL, KY, MS, TN, AR, LA, OK, TX **Mountain and Pacific:** AZ, CO, ID, MT, NV, NM, UT, WY, AK, CA, HI, OR, WA

DATA: AMERICAN SOCIETY OF PLASTIC SURGEONS, 2009

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Randi Weingarten

"Teachers have been unfairly vilified for the challenges in education. There is not a bad-teacher epidemic"

The president of the American Federation of Teachers on public education, teacher bonuses, and why unions are so unpopular



PHOTOGRAPH BY ANDY CUTRARO FOR BLOOMBERG BUSINESSWEEK

My parents were not union activists. My mother was a teacher who went on strike at terrific financial sacrifice to the family, and my father was an electrical engineer who lost his job through no fault of his own. It made me question the central notion of capitalism–that if you work hard, you'll have plenty of opportunity.

After finishing law school, I went to work on Wall Street and then became counsel at the United Federation of Teachers, the union for educators in New York City public schools. In 1998, I became president. When I first joined UFT, the city was still working through the ravages of the 1970s fiscal crisis. Schools were in disrepair and teachers were paid poorly relative to their counterparts in the suburbs.

As president, my first priority was teacher pay. One of the toughest debates was over merit pay. Bonuses for output are common in the private sector, but in public education most of the focus should be on the inputs for student success. We agreed to merit pay that recognizes the importance of collaborative efforts. We also switched our position to support mayoral control of city schools because we felt there had to be more accountability. None were easy stances.

Running for president of the American Federation of Teachers was the hardest choice I've made. I loved the challenges of New York, but there's so much work to do on the national level. Education is about creating opportunities for kids to realize their dreams while the labor movement is about trying to create opportunity in an employment setting. Teachers have been unfairly vilified for the challenges in education. There is not a bad-teacher epidemic. I think anti-union sentiment has become more vocal with the demise of the middle class. There are so few workers in unions right now that people don't see how they can help.

The Knowledge Economy requires us to transform our schools from the Industrial Age, where they're still set. Most parents send their kids to public schools and believe they're doing a good job. We need to do a better job. B —*As told to Diane Brady*

Advantage:
RIMS

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